

**RAISING RIVALS' COSTS:
ANTITRUST RAMIFICATIONS
FOR SECTION 36 OF THE COMMERCE ACT 1986**

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ABSTRACT

The Raising Rivals' Costs theory is the newest and most important theory of nonprice predation. This dissertation assesses its ramifications for s. 36 of the Commerce Act 1986. Chapter I introduces the topic. Chapter II deals with nonprice predation and shows how it is an attractive strategy for dominant firms. Chapter III discusses the RRC model in depth. Chapter IV critiques it. Chapter V deals with the constituent elements of s. 36. Chapters VI to XIV deal with examples of prohibited conduct under s. 36. In each chapter I analyse whether the theory helps explain the cases, adds anything new and is relevant. I discuss U.S., Australian and New Zealand cases.

Chapter XV concludes that the theory is relevant and useful under s. 36.

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CHAPTER I

INTRODUCTION

One of the primary concerns of antitrust law is prohibiting firms with market power from using that power to eliminate rivals or protect themselves from competition. Every system of antitrust law has misuse of market power provisions. Commentators and courts have come up with a variety of terms to describe such misuse of market power. These include "predation", "exclusionary behaviour", "abuse of market power", "foreclosure", "unfair competition", "anticompetitive behaviour", "erecting barriers to entry" and "banning access". I shall use the term predation to describe such behaviour. However, it encompasses all the above terms.

Two concerns have presented themselves about predation. First, courts and commentators have until recently limited themselves to price predation when dealing with predation. Two fundamental premises of recent antitrust law have been that a) firms behave rationally and b) because predation is irrational, firms will not engage in it. New theories have arisen which show that premise b) is not necessarily correct.

These new theories argue that predation can be a plausible and rational business strategy and thus, merits antitrust attention.

The second concern over predation is how to distinguish it from normal business behaviour. It has become axiomatic over the world that antitrust laws protect competition not competitors. In New Zealand the High Court has said:

"Such provisions [Sections 27 and 36 Commerce Act 1986] are directed at the protection of the concept of competition as such. They are not directed at the protection of individual competitors, except in so far as the latter may promote the former".¹

Similarly Barker J. stated:

"The test of competition is not concerned with the economic fate of individual competitors ...".²

The same is true in Australia In Queensland Wire Industries Pty Ltd v The Broken Hill Proprietary Co. Ltd³ Mason C.J. and Wilson J.

observed:

"the objective of s. 46 is to protect the interests of consumers, the operation of the section being predicated on the assumption that competition is a means to that end".⁴

Subsequent Australian courts have interpreted Queensland Wire to mean the goal of s. 46 is to protect consumers not competitors.⁵

The same is also true in the United States. The Supreme Court in Brown Shoe Co. v U.S.⁶ held: "It is competition, not competitors, which the [Sherman]

1 Union Shipping Ltd v Port Nelson Ltd [1990] 2 NZLR 662, 700.

2 Auckland Regional Authority v Mutual Rental Cars (Auckland) Airport) Ltd [1987] 2 NZLR 647, 653.

3 (1989) ATPR para 40-925.

4 ^a Id. at 50,010. Similarly, Deane J. held in the same case at 50,011: "the essential notions with which s. 46 is concerned and the object which the section is designed to achieve are economic and not moral ones. The notions are those of markets, market power, competitive environment and competitive conduct ...".

5 Dowling v Dalgety Australia Ltd (1992) ATPR para 41-165; ASX Operations Pty Ltd v Pont Data Australia Pty Ltd (1991) ATPR para 41-069.

6 370 U.S. 294 (1962).

Act protects".⁷

The importance of distinguishing between predation and normal business behaviour is that "[a]ll lawful competition aims to defeat and drive out competitors".⁸ Former Judge and Professor Robert Bork has noted:⁹

"... the essential mechanism of competition and its prime virtue [is] that more efficient firms take business away from the less efficient. Some businesses will shrink and some will disappear. Competition is an evolutionary process. Evolution requires the extinction of some species as well as the survival of others. The business equivalent of the dodos, the dinosaurs, and the great ground sloths are in for a bad time - and they should be".

Thus, competition law should protect competition - not preserve competitors from their more energetic rivals.

Judge Frank Easterbrook has well summed up the dilemma of distinguishing between predation and healthy competitive behaviour:¹⁰

"Aggressive, competitive conduct by a monopolist is highly beneficial to consumers. Courts should prize and encourage it under the antitrust laws. Aggressive exclusionary conduct by a monopolist is deleterious to consumers. Courts should condemn it under the antitrust laws. There is only one problem: competitive and exclusionary behaviour look alike".

7 Id. at 334.

8 Great Escape, Inc. v Union Body Co., 791 F. 2d 532, 541 (7th Cir. 1986); The Sixth Circuit Court of Appeals has observed: "[l]ively legal competition will result in the efficient and shrewd businessman routing the inefficient and imprudent from the field". Richter Concrete Corp. v Hilltop Concrete Corp., 691 F. 2d 818, 823 (6th Cir. 1982); See, also, Olympia Equipment Leasing Co. v Western Union Tel. Co., 797 F. 2d 370, 379 (7th Cir. 1986), cert. denied, 480 U.S. 934 (1987).

9 Bork, Bowman, Blake and Jones, The Goals of Anti-trust: A Dialogue on Policy, 3 65 COLUM. L. REV. 363, 375 (1965).

10 Easterbrook, On Identifying Exclusionary Conduct, 61 NOTRE DAME L. REV. 972, 972 (1986).

Thus, in deciding whether behaviour is predatory, courts must not only consider its effect on competitors, they must also consider its effect on consumers. Commentators and courts have devised various tests for distinguishing predatory and competitive behaviour.

Bork has defined predation as a "firm's deliberate aggression against one or more rivals through the employment of business practices that would not be considered profit maximizing" except for two expectations:¹¹ Either the conduct will drive competitors from the market, which would give the predator a sufficient market share to command monopoly profits, or the competitors will, through fear or a renewed spirit of cooperation, "abandon competitive behaviour the predators finds inconvenient or threatening".¹² In short, Bork defines predation as "attempting to exclude rivals on some basis other than efficiency".¹³ The United States Supreme Court has expressly adopted Bork's definition as have some Circuits.¹⁴

Professors Phillip Areeda and Donald Turner have defined predation:¹⁵

"... [E]xclusionary comprehends at the most behaviour that not only (1) intends to impair the opportunities of rivals, but also (2) either does not further competition on the merits or does so in an unnecessarily restrictive way".

11 R. BORK, *THE ANTITRUST PARADOX : A POLICY AT WAR WITH ITSELF* 144 (2d ed. 1993).

12 Ibid.

13 Id. at 138.

14 Aspen Skiing Co. v Aspen Highlands Skiing Corp., 472 U.S. 585, 605 (1985).

15 III P. AREEDA & D. TURNER, *ANTITRUST LAW* 78 (1978).

Professor Lawrence Sullivan has added his thoughts:¹⁶

"By contrast [with competitive conduct], the predator seeks not to win the field by greater efficiency, better services or lower prices reflective of cost savings or modest profits. The predatory firm tries to inhibit others in ways independent of the predator's own ability to perform effectively in the market".

A predator can engage in predation on three interrelated fronts. First, it can act so as to deter potential rivals. Such deterrence strategies need not harm the predator's existing rivals. Second, it can act so as to disadvantage existing rivals. It may not eliminate its rivals, but it may reduce the competitive restraint the rivals exercise over it. Third, it can act so as to eliminate its rivals.

All the acts may substantially deter potential rivals. They may only be rational if they have this effect. Indeed, Judge Richard Posner believes a firm's reputation for predatory behaviour can be an effective entry barrier.¹⁷

While these definitions have all received judicial approval, they, with respect, suffer from not being sufficiently able to take account of strategic behaviour. This is predatory conduct designed to decrease the attractiveness of the offers against which the predator must compete.¹⁸ Professor Oliver

16 L. SULLIVAN, HANDBOOK OF THE LAW OF ANTITRUST III (1977).

17 R. POSNER, ANTITRUST LAW : AN ECONOMIC PERSPECTIVE 184-187 (1976).

18 Markovits, The Limits to Simplifying Antitrust: A Reply to Professor Easterbrook, 63 TEXAS L. REV. 41, 44 (1984); Markovits, Some Preliminary Notes on the American Antitrust Laws' Economic Tests of Legality, 27 STAN. L. REV. 841 (1975); Hovenkamp, Antitrust Policy after Chicago, 84 MICH. L. REV. 213, 260 (1985).

Williamson defines strategic behaviour as:¹⁹

"[e]fforts by established firms to take up advance positions and respond contingently to rivalry in ways that discipline actual and discourage potential competition".

A firm acts strategically when it takes into account its rivals' reactions before acting. A predator engages in strategic behaviour to influence or constrain a competitor's market choices. In this way it can be a form of predation. No one disputes that firms can do it. The problem is that it makes the analysis more complex and correspondingly makes it more difficult to distinguish predation from normal competitive behaviour. The complexity arises from assuming (correctly) that firms operate in uncertain environments. The uncertainty results from asymmetric information among firms. Strategic behaviour scholars also assume bounded rationality or at least costs of learning. Williamson refers to these factors as transaction costs.²⁰ Transaction costs complicate the identification of conditions under which a firm's actions benefit competition. This is seen best with vertical restraints. Traditional Chicago School scholars argue that vertical restraints are seldom anticompetitive.²¹ They are only so, if they have a horizontal impact. Williamson argues that transaction costs can cause vertical restraints to be anticompetitive as a firm may

19 Williamson, Antitrust Enforcement: Where It's Been, Where It's Going, 27 ST. LOUIS U. L. J. 289, 289 (1983).

20 Ibid.; Williamson, Assessing Vertical Market Restrictions : Antitrust Ramifications of the Transaction Cost Approach, 127 U. PA. L. REV. 953, 954 (1979).

21 BORK, *supra*, note 11; Posner, The Chicago School of Antitrust Analysis, 127 U. PA. L. REV. 925, 927 (1979); Posner, The Next Step in the Antitrust Treatment of Restricted Distribution : Per Se Legality, 40 U. CHI. L. REV. 6 (1983).

choose to impose a vertical restraint to increase a rival's costs and thereby cause anticompetitive harm. This is to be contrasted with the Chicago School view that a firm only imposes a vertical restraint to reduce its own transaction costs and thereby increase its own efficiency. This argument may be correct in certain circumstances, for example, if the transaction costs of a scheme whereby all suppliers distribute their products through all distributors are very high due to transportation or negotiation costs, a vertical restraint may be efficient and thus procompetitive.

This shows the difficulty in distinguishing predation via strategic behaviour and normal business practice. Indeed, Professor William Baxter freely admits harmful strategic behaviour exists but argues courts cannot understand it and thus, should ignore it.²² That a predator can use vertical restraints to harm competition shows predation does not just have to be price predation.

Predation takes two forms, price or nonprice. With price predation, a predator sells its products at a loss so as to drive its victims from the market, then increases prices to recoup its losses and reap monopoly profits.

Nonprice predation involves a predator acting so as to raise its rivals' or potential rivals' costs. This forces the rivals to raise their price. Such action enables the predator to do likewise and make a profit. As mentioned above, until recently commentators and courts have focused mainly on price predation. This is changing as scholars, enforcement agencies and private plaintiffs realise that nonprice predation is a more attractive strategy and this more likely to

22 Baxter, Reflections Upon Professor Williamson's Comments, 27 ST. LOUIS U. L. J. 315, 316 (1983).

occur.²³

Various theories of nonprice predation have emerged. I will focus on one; viz, Professors Steven Salop, Thomas Krattenmaker and David Scheffman's model of Raising Rivals' Costs. I will assess whether it is relevant to New Zealand competition law. To do so entails examining whether it takes account of strategic predatory behaviour and enables courts to do so. Chapter II will introduce and discuss the concept of nonprice predation and how it is an effective anticompetitive theory. It will compare nonprice predation with price predation and show how it is a much more plausible strategy.

Chapter III will discuss the Raising Rivals' Costs Model. Chapter IV critiques the model. Chapter V will analyse the constituent elements of Section 36 Commerce Act 1986. Section 36 is New Zealand's predation section. I will argue that it can and does enable courts to distinguish between predatory and normal business behaviour. To assess whether the Raising Rivals' Costs model is relevant to New Zealand I will examine whether it fits in with existing case law under section 36 and whether it is useful in deciding section 36 cases. To that end Chapter VI will discuss price squeezes and the model. Chapter VII will discuss refusals to deal and the model. Chapter VIII will deal with overbuying and capacity expansion. Chapter IX will deal with predatory innovation. Chapter X will examine predatory hiring. Chapter XI will deal with predatory

23 See Calvani & Averitt, Nonprice Predation: An Introduction, 16 J. REPRINTS FOR ANTITRUST L. & ECON., No. 2 (1986); Its importance is recognised by the Antitrust Section of the American Bar Association having published a monograph on the subject: ABA ANTITRUST SECTION: MONOGRAPH NO. 18, NONPRICE PREDATION UNDER SECTION 2 OF THE SHERMAN ACT (1991).

advertising. Chapter XII will examine predatory litigation which is a paradigm Raising Rivals' Costs scenario. Chapter XIII deals with a possible future application of the model in the United States. Chapter XIV analyses exclusive dealing and the model. Chapter XV concludes that the model is relevant in assessing predation under the Commerce Act.

As New Zealand's competition law is still in its infancy I will refer to overseas authority and commentary.

I assume a number of things for the purpose of the dissertation.

I assume the goal of antitrust is to enhance efficiency. Krattenmaker and Salop assume this, so any assessment of their model must share their assumption. The assumption is controversial. I believe it is justifiable.

Efficiency has three components.

(1) Productive or X Efficiency²⁴

This occurs when it is impossible to produce more of at least one product, without simultaneously producing less of another product. It simply means that an individual firm is making the most effective use of its resources (i.e. it cannot make the product any cheaper).

(2) Allocative Efficiency²⁵

This occurs when products are allocated in such a way that no other combination of products would enhance the well-being of one consumer without

24 See, R. BLAIR & D. KASSERMAN, ANTITRUST ECONOMICS 24 (1985); E. MANSFIELD, MICROECONOMICS: THEORY & APPLICATIONS (4th ed. 1982); D. McCLOSKEY, THE APPLIED THEORY OF PRICE (1982); G. STIGLER, THE THEORY OF PRICE (3d ed. 1966).

25 Ibid.

affecting another consumer. In economic terms an industry obtains allocative efficiency if output is at the level where price equals the marginal cost of production.

(3) Dynamic or Intertemporal Efficiency²⁶

This refers to the degree to which society is finding the optimal balance between satisfying current and future wants through savings and investment or innovation. Proponents of dynamic efficiency argue it is the most important aspect of efficiency.²⁷

When I refer to consumer welfare in this dissertation I mean allocative efficiency. As Bork notes:²⁸

"Consumer welfare is maximised when society's economic resources are allocated so that consumer wants are satisfied as fully as technological constraints permit. Simply put, consumer welfare is the measure of a nation's wealth".

He argues:²⁹

"The whole task of antitrust can be summed up as the effort to improve allocative efficiency without impairing productive efficiency so greatly as to produce either no gain or net loss in consumer welfare".

26 Ibid.

27 J. SCHUMPETER, CAPITALISM, SOCIALISM AND DEMOCRACY, 81-106 (1942); F. SCHERER, INNOVATION AND GROWTH: SCHUMPETERIAN PERSPECTIVES (1984); M. PORTER, COMPETITIVE ADVANTAGE OF NATIONS (1990); Scherer, Antitrust, Efficiency and Progress, 62 N.Y.U.L. REV. 998, 1010-1012 (1987); Markham, Concentration : A Stimulant or Retardant to Innovation?, in INDUSTRIAL CONCENTRATION : THE NEW LEARNING 247 (H. Goldschmid, H. Mann & J. Weston eds. 1974).

28 BORK, *supra*, note 11 at 91.

29 Id. at 90.

Productive and allocative efficiency are static elements. They are part of a market at one point in time. Efficiency, as mentioned above, has a third component, viz; dynamic efficiency. Consumer welfare antitrust analysis ignores dynamic efficiency. Its arguments and models are based on static efficiencies alone.

The Consumer Welfare School is not the only antitrust school. Many models exist. However, I condense them into four. I shall examine each.

1. **Structuralist Model**

This model has the objective of maximising consumer welfare. It assumes that one can identify conduct which harms competition by examining the market structure in which the conduct occurs. It has as its key model the structure-conduct-performance paradigm.³⁰ This paradigm holds that ultimately market structure affects consumer welfare.³¹ The argument runs as follows - structure induces conduct that determines performance; i.e. a low concentration market structure with many firms induces competition with the lowest prices. Low prices mean that consumer welfare is at its maximum, as the market produces an efficient amount without monopoly profits. Conversely, a high concentration of firms leads to a decrease in output and a raising of prices causing monopoly profits and a supply of less than optimal amount and a decrease in consumer

30 See, Carstensen, Antitrust Law and the Paradigm of Industrial Organisation, 16 U.C. DAVIS L. REV., 487 (1983); Weiss, The Structure -Conduct-Performance Paradigm and Antitrust, 127 U. PA. L. REV., 1104 (1979).

31 F. SCHERER, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE 3-6 (2d ed. 1980).

welfare.

Thus, the structuralist model aims to reduce market concentration and maintain numerous firms or an atomistic market. In short, it tries to obtain a situation as close to perfect competition as possible.

This leads to concern about the number of competitors in a market. The more, the better. A dominant firm's conduct which eliminates or forecloses rivals and thus, increases concentration will be illegal. A court need not assess the impact of conduct on price or output or production efficiency, as structure determines performance. Williamson terms the model the "inhospitality tradition",³² as it views all conduct which forecloses rivals as anticompetitive and illegal per se, without requiring a plaintiff to show that conduct is anticompetitive.

Critics claim the model is too simplistic.³³ No proof exists that structure causes conduct which determines performance. Professors Howard Demsetz³⁴ and Yale Brozen³⁵ argue no empirical evidence supports a causal connection between concentration and profitability. A concentrated market be highly competitive, for example, two firms, Coke and Pepsi dominate the soft drink market and no one suggests that the market is not highly competitive.

32 Williamson, *supra*, note 20, at 989.

33 Carstensen, *supra*, note 30, at 501-504.

34 Demsetz, Industry Structure, Market Rivalry, and Public Policy, 16 J.L. & ECON., 1 (1973).

35 Y. BROZEN, CONCENTRATION, MERGERS AND PUBLIC POLICY (1982); Brozen, Bain's Concentration and Rates of Return Revisited, 14 J.L. & ECON., 351 (1971).

Conversely, a market with numerous firms may not be highly competitive in the sense of low prices. Numerous real estate agent firms exist in New Zealand yet one is hard pressed to find wide varieties in the percentages these firms charge as commissions. If the structural model was correct one would not expect to find this.³⁶ Indeed some commentators argue that the paradigm should flow the other way:³⁷

"[Exceptional] performance and competitive conduct lead to a concentrated structure. Structure is a result not the cause".

Similarly, that highly concentrated industries are profitable is not determinative. The profitability may be due to such things as economics of sale, innovation, cost reduction through production efficiencies and the like.³⁸

The structuralist model does not apply to New Zealand. The Commerce Act does not attack size alone. It does not condemn a dominant firm for its dominance - it condemns it for its conduct and its purpose. Similarly, the merger provisions do not condemn a merger solely for its size or market share. The Act allows the Commerce Commission to take efficiencies into account. It allows a merger where the efficiency gains offset any lowering of competition.

36 The possibility remains that the various real estate agent firms have formed a cartel.

37 BROZEN, *supra*, note 35, at 118; see also D. ARMENTANO, *ANTITRUST AND MONOPOLY : ANATOMY OF A POLICY FAILURE* 40 (1981).

38 Werden, Can the Concentration-Collusion Hypothesis be Refuted Empirically?, U.S. Department of Justice, Economic Policy Office, 84-11. (1984).

2. Deconcentration Model:

This model encompasses political goals, such as the preservation of small businesses, decentralisation of political power, fairness in the market place and increasing consumer choice. Americans call this Jeffersonian protection of small businesses. It also has the goal of maximising consumer welfare. It recognises that the political goals and consumer welfare goals may conflict. For example, a merger or economies of scale may increase concentration but create efficiencies which make the consumer better off in terms of lower prices than with a less concentrated market. Proponents of the model would be willing to offset the efficiency increases for a market structure in which political and economic power does not rest with a few large corporations. Professor Robert Pitofsky argues that excessive concentration will lead to antidemocratic political pressures and will decrease individual and business freedoms by broadening the range within which private decisions by a few in the economic sphere control the welfare of all.³⁹ When antitrust goals conflict, decentralisation of economic and political power prevails. Pitofsky states:⁴⁰

"[T]he matter of efficiencies is not dispositive, and ... an occasional loss of efficiency as a result of antitrust enforcement can be tolerated and is to be expected if antitrust is to serve other legitimate values".

Proponents argue in most cases courts will not have to offset efficiency

39 Pitofsky, The Political Content of Antitrust, 127 U. PA. L. REV., 1051 (1979).

40 Id. at 1074.

for deconcentration as economies of scale are not substantial.⁴¹ They do not believe one can quantify efficiencies. This uncertainty and the belief that entry barriers are large and that pricing above marginal costs occurs at relatively low concentration levels implies that antitrust should maintain low concentration levels unless one can show efficiencies.⁴²

Preserving or increasing consumer choices is also a goal of antitrust. Proponents criticise exclusive dealing, for example, as reducing the price/quality options for consumers.⁴³

This model leads to a bewildering number of reasons for antitrust decisions. The U.S. Supreme Court, particularly under Chief Justice Earl Warren, held mergers might be illegal because:-

1. it would require moving a corporation's headquarters from a small town to a large city,⁴⁴
2. it is part of a trend lessening the number of single-store groceries,⁴⁵
3. it may eliminate a potential rival which every firm in the market ignored,⁴⁶

41 SULLIVAN, *supra*, note 16, at 447-448; Bain, Economies of Scale, and the Conditions of Entry in Twenty Manufacturing Industries, 44 AM. ECON. REV., 15 (1954).

42 Hovenkamp, *supra*, note 18, at 218.

43 Fox, The Modernization of Antitrust: A New Equilibrium, 66 CORNELL L. REV., 1140 (1981); Fox, Consumer Beware Chicago, 84 MICH. L. REV., 1714 (1986).

44 U.S. v Falstaff Brewing Corp., 410 U.S. 526, 541-42 (1973) (Douglas J., concurring).

45 U.S. v Von's Grocery Co., 384 U.S. 270, 278 (1966).

46 *Supra*, note 44, at 537.

4. it may eliminate competition among certain firms that may or may not compete in the relevant market.⁴⁷

On the other hand, the Court allowed mergers or agreements among rivals to restrict output because:-

1. it permitted a dying industry to keep up its profits until it expired,⁴⁸
2. it enabled firms to decrease their work day,⁴⁹
3. it enabled firms who did not want to compete not to compete.⁵⁰

The problem with the model is that it does not allow a rational analysis of antitrust cases. The law becomes unpredictable. An absurd example is s. 7 of the Clayton Act. A senator, when speaking on a proposed amendment, spoke of child mortality being higher in cities with high levels of industrial concentration. This leads to the possibility of opposing a merger on the basis of it increasing child mortality.⁵¹ This is not rational - it is as Bork says "intellectual mush".⁵²

47 U.S. v Pabst Brewing Co., 384 U.S. 546, 549 (1966).

48 National Association of Window Glass Manufacturers v U.S., 263 U.S. 403, 412 (1923).

49 Chicago Board of Trade v U.S., 246 U.S. 231, 241 (1918).

50 Appalachian Coals v U.S., 288 U.S. 344, 376-377 (1933).

51 Barnett, Bork, Joffe, Axinn, Kantor, Panel Discussion: Merger Enforcement and Practice, 50 ANTITRUST L.J. 233, 238 (1981).

52 Ibid. Easterbrook argues "a multiple-goal antitrust policy is unpredictable and unprincipled", see Easterbrook, Is There a Ratchet in Antitrust Law? 60 TEX. L. REV., 705, 716 (1982).

3. Chicago School or Consumer Welfare Model

The Chicago School model condemns only those practices which confer power to reduce output and increase price. Its primary goal is to maximise consumer welfare by maximising productive efficiency and leading to lower prices for consumers.⁵³ Indeed, Judge Easterbrook claims that "[t]he principal purpose of the antitrust laws is to prevent overcharges to consumers".⁵⁴

Highly concentrated markets are not necessarily anticompetitive.⁵⁵ They do not necessarily confer power over price as they may be highly competitive. Similarly, increased concentration may also result in efficiencies which benefit consumers by leading to lower prices or better products or services. Thus, one must analyse each practice which leads to higher concentration and determine whether it is anticompetitive. Antitrust protects competition not competitors. That a practice harms a competitor is not determinative. It is the nature of competition that some firms will eliminate other less efficient firms.⁵⁶ The other two models state that antitrust protects the process of rivalry. The Chicago School interprets competition as a process of rivalry, not a state at a slice of

53 See, *supra*, note 21; See also R. POSNER, *ANTITRUST LAW : AN ECONOMIC PERSPECTIVE* (1976); H. HOVENKAMP, *ECONOMICS AND FEDERAL ANTITRUST LAW* (1985); Hovenkamp, *supra*, note 18, 226-233.

54 Premier Electrical Const. Co. v National Electrical Contractors Ass'n. Inc., 814 F. 2d 358, 368 (7th Cir. 1987).

55 BORK, *supra*, note 11, at 179-191; Y. BROZEN, *CONCENTRATION MERGERS AND PUBLIC POLICY* (1982); J. McGEE, *IN DEFENCE OF INDUSTRIAL CONCENTRATION* (1971).

56 Easterbrook, *supra*, note 10 at 973; Bork, *supra*, note 9.

time. A firm may create a superior product. It thus, obtains greater sales and profits. However, as the firm does not own its customers the fact that the firm has a large share of today's sales does not imply injury. The firm may be doing the thing that benefits consumers - making its product more efficiently and selling at lower prices. The only antitrust concern is if the firm does something which prevents new entrants similarly innovating and growing.

The Chicago School only condemns dominant firm behaviour which gives the dominant firm the power to reduce output and raise prices. Similarly, the Chicago School argues barriers to entry are not prevalent. Professor George Stigler defines them as "additional long-run costs that must be incurred by an entrant relative to the long-run costs, faced by incumbent firms".⁵⁷ Thus, if the incumbent firm had to meet the same cost that an entrant does it is not an entry barrier. For example, if entrants could compete in a market by building a factory and investing in personnel, the fact the incumbent has a factory and has invested in personnel is not an entry barrier.

An example of the difference between the Chicago School and the other models is marked over vertical restraints. The Chicago School assumes they are seldom anticompetitive.⁵⁸ Critics dispute the Chicago School's assumptions that the private interests of the firms entering into vertical restraint agreements (such as exclusive dealing) and the public interests of the consumer always coincide.

57 G. STIGLER, *THE ORGANISATION OF INDUSTRY* 67 (1968); The U.S. Federal Trade Commission adopted this definition in *Echlin Manufacturing Co.*, 105 F.T.C. 410, 485 (1985).

58 See, *supra*, note 21; Easterbrook, *Vertical Arrangements and the Rule of Reason*, 53 ANTITRUST L.J., 135, 168 (1984) "Vertical arrangements almost never threaten competition".

They also note the School virtually ignores the degree to which vertical restraints reduce price/quality options.⁵⁹

Efficiencies are determinative for Chicagoans. If the conduct leads to efficiencies, courts should allow it. Pitofsky, on the other hand, only allows efficiencies "when the likelihood of competitive injury was slight, the predicted efficiencies were capable of clear demonstration in court, and there was some likelihood that the efficiencies would be converted into significant competitive effects".⁶⁰ The Chicago School believes that efficient conduct is probable and argues that efficiencies or at least no anticompetitive effect should be presumed if the conduct does not confer power over price.

4. Strategic Behaviour Model or Post Chicago School

This model, like the Consumer Welfare Model also has the principal concern of preventing overcharging to consumers. Efficiency, is the goal of the antitrust laws. However, unlike the Consumer Welfare Model it does not assume that such things as vertical restraints are efficient or neutral. Adherents argue antitrust should take account of strategic behaviour which has the aim of imposing costs on rivals.⁶¹ As mentioned above, a firm engages in strategic behaviour to influence or constrain a competitor's market choices. The Consumer Welfare Model downplays and often ignores the strategic dimension of firm behaviour. As such, it contrasts with modern industrial economics where

59 See, Fox, *supra*, note 43.

60 Pitofsky, *supra*, note 39, at 1075.

61 See, Williamson, *supra*, notes 19 and 20.

theoretical progress in the understanding of strategic behaviour has displaced the uncritical application of standard static microeconomic models. Adherents argue things the Consumer Welfare School regard as efficient or neutral can actually harm consumer welfare as they impose costs on rivals. This may give the strategic firm the power over price which will prevent price falling.

Thus, a key difference between the Consumer Welfare and Strategic Behaviour models is the role of intent. Consumer Welfare proponents eschew the relevance of intent in antitrust. Professor Harold Demsetz has argued: "much would be gained and little lost if evidence on 'intent' ceased to be thought relevant".⁶²

However, strategic model adherents think differently.⁶³

"Lawrence Sullivan, for example, argues that we should look to purpose or intent in any examination of the antitrust consequences of particular events. While emphasizing that lawyers, judges and juries deal competently with such concerns, he writes that: "purpose may be the last factor about which an economist would ask when analyzing market conduct". While this statement may be correct when economic analysis is limited to standard price theory, it is hardly so when the broader concerns of strategic behavior are taken into account. Purpose and intent become important elements in determining the competitive consequences of various strategic actions. A major implication of the recent emphasis on strategic behavior may be a new acceptance of the role of these considerations in antitrust analysis".

The Consumer Welfare School also emphasises elimination of rivals. The Strategic Behaviour Model emphasises that exclusion need not be total to have

62 Demsetz, Barriers to Entry, 72 AM. ECON. REV., 45, 49 (1982).

63 Comanor & Frech III, Strategic Behaviour and Antitrust Analysis, 74 AM. ECON. REV., 372, 378 (1984).

a potentially negative effect on consumer welfare.⁶⁴ Krattenmaker and Salop's RRC model is part of the Strategic Behaviour Model.

The above discussions are necessarily brief outlines of the above models. One must ask what model does the Commerce Act adopt. I have already argued it does not incorporate the Structuralist Model.

Despite the U.S. Supreme Court, in Reiter v Sonotone,⁶⁵ having held that the goal of the antitrust laws is to enhance consumer welfare, a long and vigorous debate rages in the U.S. over the goals of antitrust.⁶⁶ Much of this turns over the legislature's intention in enacting the Sherman Act. Bork argued the legislature's sole purpose was the forwarding of consumer welfare.⁶⁷ This produced a flurry of articles arguing the opposite. Professor Richard Hofstadter claimed one of the goals was avoidance of concentrated economic power as a threat to democratic government.⁶⁸ Professors Blake and Jones argue that in addition to economic efficiency, the Sherman Act was intended to promote the political goals of self-policing markets and protecting individual freedom and

64 Ordoover & Saloner, Predation, Monopolisation, and Antitrust in HANDBOOK OF INDUSTRIAL ORGANISATION 537-96 (R. Schmalensee & R. Willig eds. 1989).

65 442 U.S. 330 (1979).

66 For a review of shifting economic and political ideologies over the history of the Sherman Act, see generally E. SULLIVAN, THE POLITICAL ECONOMY OF THE SHERMAN ACT ; THE FIRST ONE HUNDRED YEARS (1990).

67 Bork, Legislative Intent and the Policy of the Sherman Act, 9 J.L. & ECON., 7 (1966); BORK, *supra*, note 11, at 50-71.

68 R. HOFSTADTER, What Happened to the Antitrust Movement?, in THE PARANOID STYLE IN AMERICAN POLITICS AND OTHER ESSAYS 199-200 (1965).

economic opportunity.⁶⁹ Professor Herbert Hovenkamp⁷⁰ and Professor Robert Lande⁷¹ argue Congress' overriding concern was protecting consumers from wealth transfers. Pitofsky claims political values as well as economic ones influenced the Congress.⁷² No one will ever resolve the debate.⁷³

The Australian Parliament expressed concerns about protecting small businesses. On the Second Reading Speech explaining the 1986 amendments to s. 46, Attorney-General Bowen said:⁷⁴

"A competitive economy requires an appropriate mix of efficient businesses, both large and small. Whilst large enterprises may frequently have advantages of economies of scales there are many occasions when large size does not of itself mean greater efficiency. However a large enterprise may be able to exercise enormous market power, either as a buyer or seller, to the detriment of its competitors and the competitive process. Accordingly, an effective provision controlling misuse of market power is most important to ensure that small businesses are given a measure of protection from the predatory actions of powerful competitors".

The Whitlam Labour Government enacted the Trade Practices Act.

69 Blake & Jones, Toward a Three-Dimensional Antitrust Policy, 65 COLUM. L. REV. 422, 425-36 (1965).

70 Hovenkamp, Distributive Justice and the Antitrust Laws, 51 GEO. WASH. L. REV. 1 (1982); Hovenkamp, Well-Being and Public Choice, 57 U. CHI. L. REV., 63, 74-94 (1990).

71 Lande, Wealth Transfers as the Original and Primary Concern of Antitrust: The Efficiency Interpretation Challenged, 34 HASTINGS L.J. 65 (1982).

72 Pitofsky, *supra*, note 39; see also Schwartz, "Justice" and Other Non-Economic Goals of Antitrust, 127 U. PA. L. REV., 1076 (1979).

73 Bork, has published a rejoinder to his critics in the new edition of the Antitrust Paradox, BORK, *supra*, note 11, at 426-429.

74 Second Reading Speech, Australian Federal Parliament 1986.

Given that Government's record, protection of small businesses must have been one of its goals.

The fourth Labour Government enacted the Commerce Act in totally different circumstances. It radically reformed New Zealand's economy and previously regulated and protectionist structures. It proceeded on the philosophy that it had to restructure New Zealand's economy and industry to make it more efficient. By making it more efficient, New Zealand industry would become more competitive. High local costs due to inefficient, import-protected and heavily subsidised local supplies were hindering New Zealand's international competitiveness. Thus, New Zealand industry had to become more efficient. Consequently, the Government abolished import licensing tariffs, progressively removed subsidies, reduced direct income tax, relaxed rules on foreign investment, floated the dollar and abolished runs on foreign currency coming into New Zealand. It privatised State-owned monopolies and sold some to overseas owners. It also enacted the Commerce Act. It intended the Commerce Act to be the sole regulator of market behaviour. No more government regulation, just the Commerce Act. The Parliamentary Debates reveal no concern about the fate of small businesses, centralisation of political power and "small dealers and worthy men".⁷⁵ The key phrase was efficiency. Lindsay Hampton shows how Parliament changed the wording of s. 36 to prevent it from condemning a "highly efficient market-dominant firm from competing aggressively or from taking advantage of its economies of scale, its new product

75 Chicago Board of Trade v U.S., 246 U.S. 231, 239 (1918).

development or exclusive distribution arrangements".⁷⁶ Parliament did not discuss political goals for the Commerce Act, so one can assume it did not intend the Act to have them. Efficiency is the goal. This is not to suggest that political goals are irrelevant to New Zealand antitrust. They are relevant. However, they should not override the efficiency goal. By focusing on efficiency antitrust will also achieve complementary political goals.⁷⁷ By preventing a dominant firm from using its dominant position for anticompetitive purposes s. 36 achieves the necessary result of protecting smaller firms and increasing their economic opportunity. The Act's history offers no support for courts choosing non-efficiency political goals over efficiency goals. The whole idea of that goes against the theme of light-handed regulation. Courts cannot use the Commerce Act to achieve political goals when the whole scheme of reform was light-handed regulation. The Government indicated it wanted to get out of the market place. Courts cannot use the Commerce Act to impose judicial legislation to further what they view as justifiable political goals. If they did it would be a naked judicial usurpation of Parliament's role.

Case law on the Commerce Act indicates that efficiency is the goal.

Richardson J. in Tru Tone v Festival Records⁷⁸ observed:

76 Hampton, Section 36(1) of the Commerce Act 1986: An Analysis of its Constituent Elements, in COMPETITION LAW AND POLICY IN NEW ZEALAND 179, 194, 200 (R. Ahdar ed. 1991).

77 BORK, *supra*, note 11, at 428-429; Brunt, Australian and New Zealand Competition Law and Policy, in 1992 FORDHAM CORPORATE LAW INSTITUTE PROCEEDINGS, 131, 164-167 (1993).

78 [1988] 2 NZLR 352.

"In terms of the long title the Commerce Act is an act to promote competition in markets in New Zealand. It is based on the premise that societies' resources are best allocated in a competitive market where rivalry between firms ensures maximum efficiency in the use of resources".⁷⁹

Indeed the Court of Appeal's judgment indicates they do not view rivalry as simply large numbers of firms competing. It views it as a process of rivalry - not as a state at a slice in time. The case involved maximum resale price fixing. The defendant sought to fix maximum retail prices for its records, as a condition of supplying them to the plaintiffs. The plaintiffs were retail outlets for albums. They brought action under s. 36 and s. 27. The s. 36 case turned on market definition. The plaintiffs argued a single album definition of the market. Each album was a single market and the defendant as sole supplier was dominant in that market. Both the High Court and Court of Appeal refuted this. Richardson J. observed:⁸⁰

"Viewed in relation to product and time the single album definition of market ignores commercial realities. It focuses on short run phenomenon. It represents a snapshot rather than a moving picture of commercial reality".

The same criticism applies to those who say competition is large numbers of rivals. A market may have few or one firm. This may be due to that firm being the best and most efficient competitor. It may be the most innovative and efficient. Its products may be cheaper and better than others. If so, it will necessarily eliminate rivals. Every successful competitive practice has victims. The more efficient the firm, the more victims it has. Joseph Schumpeter called

79 Id. at 358.

80 Id. at 360.

competition a "gale of creative destruction".⁸¹ The competition gale destroys the inefficient, the non-innovative, the fat and lazy firms. Courts should not be concerned at the elimination of such firms. It is the natural law of competition. Yet those who view competition as requiring numerous rivals are. Their attitude is akin to a conservation attempt for inefficient firms - Bork's dinosaurs, giant sloth bears and dodos.⁸² By stressing market definition is not a short run phenomenon, the Court of Appeal is emphasising that the number of rivals existing at any one time is not determinative.

Other New Zealand court's have also stressed that competition destroys and Courts should not be solely concerned with the fate of individual firms.

Barker J. and Mr R.G. Blunt commented in Union Shipping v Port Nelson.⁸³

"Such provisions [Section 27 and 36] are directed at the protection of the concept of competition as such. They are not directed at the protection of individual competitors, except in so far as the latter may promote the former".⁸⁴

Tipping J. in Magic Millions Ltd v Wrightson Bloodstock Ltd⁸⁵ observed:

"I would venture the following proposition. It is not a breach of s.36 if a person, albeit with a dominant position, simply acts in a competitive manner. It would be an irony if such conduct could be attacked because it is competition which the Act is designed to

81 J. SCHUMPETER, CAN CAPITALISM SURVIVE? 24 (1978).
J. SCHUMPETER, CAPITALISM, SOCIALISM AND DEMOCRACY 82 (1942).

82 Bork, *supra*, note 9, at 375.

83 [1990] 2 NZLR 662.

84 *Id.* at 700.

85 [1990] 1 NZLR 731.

promote".⁸⁶

If a person acts in a competitive manner it will eliminate, injure or destroy some rivals. Other New Zealand courts have made similar comments.⁸⁷

Even proponents of the deconcentration school accept antitrust cannot protect small, inefficient firms.⁸⁸ Pitofsky states he advocates the protection not of "small inefficient competitors" but of competition.⁸⁹ Small competitors are only protected against unfair tactics, unrelated to superior skill or efficiency. One can only show that protecting small inefficient firms is harmful by looking at antitrust through the use of price theory, i.e. the Chicago methodology. One can show this graphically.⁹⁰

86 Id. at 761.

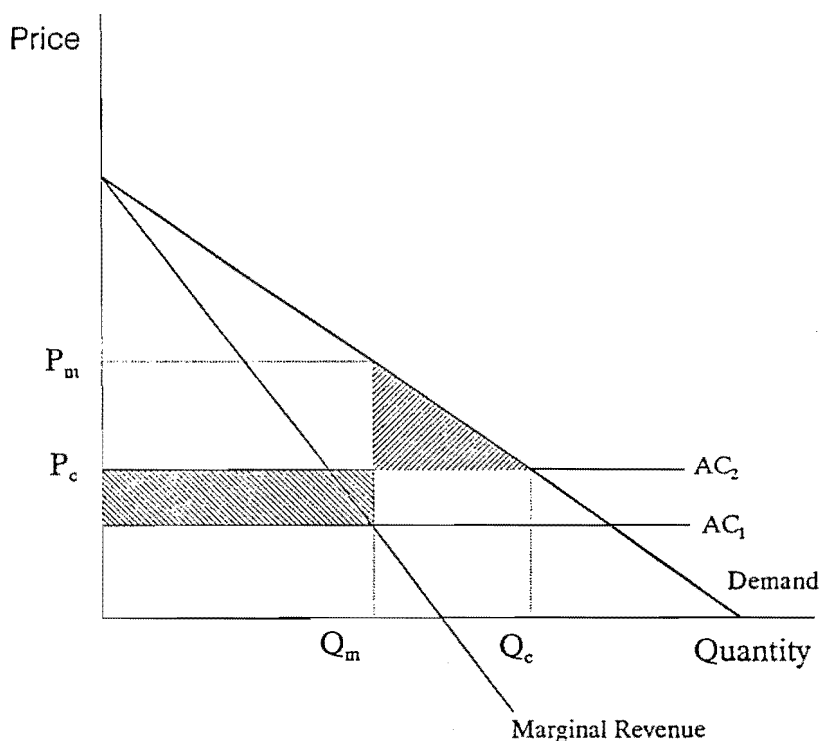
87 Hyde v Topmilk Limited, Unreported H.C., Whangarei, C.P. 52192, 50; Byers v Northland Dairy Products Limited, Unreported H.C. Whangarei, C.P. 65192, 24.

88 Scherer, *supra*, note 27, at 1016.

89 Pitofsky, *supra*, note 39 at 1059.

90 This is based on R. POSNER, *ANTITRUST LAW: AN ECONOMIC PERSPECTIVE* 243 (1976).

Graph 1



This shows the welfare loss from monopoly and inefficient production. The monopolist can manufacture goods at price AC_1 , while firms in a competitive market cannot make it at price less than AC_2 . The loss from monopoly is the inability of consumers who value the product at more than p_c , the competitive price, but at less than p_m , the monopoly price to buy the product. (This is the shaded triangle.) The productive loss from competition is the greater cost of producing goods at AC_2 rather than AC_1 , times q_m (the quantity of goods the monopolist produces). (This is the shaded rectangle.)

Professor George Hay argued that protecting inefficient rivals can benefit society.⁹¹ However, not for political reasons. He argued eliminating inefficient rivals can harm productive efficiency. From the graph, if society has to choose

91 Hay, A Confused Lawyer's Guide to the Predatory Pricing Literature, in STRATEGIC PREDATION AND ANTITRUST ANALYSIS (S. Salop ed. 1981).

between allocative inefficiency and productive inefficiency - it compares the two losses. If the triangle is smaller than the rectangle society should prefer the monopolist with efficient production. If the triangle is larger society would prefer inefficient production for the sake of efficient allocation.⁹² Hay argued that eliminating less efficient firms forces society to choose. If inefficient firms enter they may cause the monopolist to do nothing - thus, maintaining the allocative loss. They may cause the monopolist to reduce price thus, eliminating the allocative loss yet cause a loss in productive efficiency. If the monopolist eliminates the new comers by reducing price it perpetuates the allocative loss. Thus, Hay concludes antitrust should prevent dominant firms eliminating less efficient firms where it would lead to perpetuating an allocative inefficiency greater than productive inefficiency from tolerating the less efficient rivals.

However, the argument is not compelling. If a firm develops a new technology which it enables it to produce at far less cost it, will be able to make products cheaper than its rivals. It will price at less than its rivals' marginal costs, but higher than its own costs. This will eliminate its rivals, as they can't sell at the market price unless they too can reduce costs. Once the firm has eliminated its rivals it could raise its price to monopoly levels. However, the process of innovation is beneficial. No one wants to stop an innovative firm

92 For a discussion on the tradeoff between allocative efficiency and productive (X) efficiency see Liebenstein Allocative Efficiency vs. "X Efficiency", 56 AM. ECON. REV. 392 (1966); Stigler, The Xistence of X-efficiency, 66 AM. ECON. REV. 213 (1976); Liebenstein, X-efficiency Xists - Reply on an Xorcist, 68 AM. ECON. REV. 203 (1978); Williamson, Economics as an Antitrust Defence: The Welfare Tradeoffs, 58 AM. ECON. REV. 18 (1968); Williamson, Economics as an Antitrust Defence Revisited, 125 U. PA. L. Rev. 699 (1977).

from growing at the expense of its rivals. Stopping such growth reduces or eliminates the incentive for decreasing costs in the first place, as the innovative firm will not be able to achieve the full gains of innovation. This shows the misplaced logic of those who argue that antitrust should ensure a number of firms in any given market in order to encourage innovation.⁹³ If antitrust does this, it will discourage the very innovation it seeks to encourage. Why innovate if antitrust will penalise you for having done so and eliminated your rivals? Innovation which eliminates inefficient rivals, also benefits society as the low cost method of production is applied to the largest share of production.

Similarly, antitrust cannot force the successful innovator to tolerate less efficient new rivals who enter after the innovator has eliminated its original rivals. Again, this will reduce the incentive to innovate. To protect inefficient rivals is to harm competition. Granted, the successful innovator will be able to monopoly price. These prices will attract new entrants who will only succeed if they are more efficient than the original innovator. Eventually, they will. However, it may take a long time. Antitrust should only concern itself with behaviour by the monopolist which eliminates rivals on some basis other than efficiency.

While the structural model and Chicago School differ - the differences are not as marked as they once were.⁹⁴ No one argues an antitrust claim on the basis of political non-efficiency goals any more. It is all economic analysis. The

93 See SCHUMPETER, *supra*, note 27 (3d ed); He argues dynamic efficiency is improved through rapid technological change which is most likely with a structure of loose oligopoly.

94 Posner, *supra*, note 21, 925.

U.S. Supreme Court has not decided on political non-efficiency goals since 1977. By treating efficiency as the goal of antitrust courts make the law more certain and intellectually respectable. Thus, efficiency should be and is the goal of antitrust.

Commentators have raised a number of objections to this. I deal with each in turn.

Ahdar argues the Commerce Act's goal cannot be efficiency as the New Zealand Parliament rejected a Business Roundtable submission to change the long title of the Act from promotion of competition in markets to the promotion of efficiency.⁹⁵ By doing so Parliament, presumably, was saying efficiency was not the goal. However, as I argued above, the New Zealand Parliament showed no interest in non-efficiency, political goals in enacting the Commerce Act. No cases have expressed non-efficiency, political goals. It was unnecessary to expressly say efficiency is the goal. It already is.

Another criticism is that the consumer welfare model is based on static efficiency and takes no account of dynamic efficiency. The idea of dynamic efficiency derives from the work of Professor Joseph Schumpeter.⁹⁶ He was concerned with innovation in products and techniques, rather than static allocative efficiency. What was important was ensuring that antitrust maintained the best environment for innovation. Professor Michael Porter has developed the idea by arguing antitrust should advance consumer welfare by focusing on

95 Ahdar, Exclusive Dealing and the Fisher & Paykel Saga 15 NZULR 1, 43 (1992).

96 SCHUMPETER, *supra*, notes 27 and 93.

long-term dynamic efficiencies. He argues society is better off with firms that are bringing new and better products to the market. Thus, antitrust should ensure the market maximises the likelihood of continuing technological innovation, even at the cost of higher short term production costs.⁹⁷

The necessary result of this, is to ensure the maximum number of possible firms in a market. In 1975 Schumpeter argued that near atomistic markets (a loose oligopoly) encourage innovation.⁹⁸ Monopoly does not lead to innovation. This is in line with Judge Learned Hand's view in U.S. v Aluminium Co. of America⁹⁹ (Alcoa). Judge Hand observed:¹⁰⁰

"[M]any people believe that possession of unchallenged economic power deadens initiative, discourages thrift and depresses energy, that immunity from competition is a narcotic, and rivalry is a stimulant, to industrial progress; that the spur of constant stress is necessary to counteract an inevitable disposition to let well enough alone".

Whether Judge Hand is correct is unclear. No rigorous economic theory exists that correlates innovation with the number of competing firms. Indeed, a number of problems exist with the idea of encouraging dynamic efficiency by ensuring numerous rivals. First, to do so will be to protect inefficient rivals. Not even dynamic efficiency proponents such as Professor Frederic Scherer argue that antitrust should do that.¹⁰¹ As I have argued above, protecting inefficient

97 PORTER, *supra*, note 27.

98 SCHUMPETER, *supra*, note 93.

99 148 F. 2d 416 (2d Cir. 1945).

100 *Id.* at 427.

101 Scherer, Predatory Pricing and the Sherman Act : A Comment, 89, HARV. L. REV., 869 (1976).

rivals reduces the incentive to innovate. The incentive to innovate is to crush one's rivals, dominate the market and reap monopoly profits. An antitrust policy which meant one could not dominate the market, reduces the incentive to innovate. It encourages innovation to a certain success level and then yells stop.

Second, the dynamic efficiency premise is based on the premise that innovation is due to serendipity - from a large number of firms trying to innovate. That is true in some markets. The personal computer and computer software industry show this. Many of the advances came from small firms working in Silicon Valley.¹⁰² However, it is not true in other markets. Some innovation results from heavy investment in research and development - something only a large dominant firm can afford. Indeed, Schumpeter originally argued that large, dynamic firms were the causative impetus required to maintain dynamic competition. Small firms, in Schumpeter's view, lacked the resources to innovate.¹⁰³ One can see that large size is needed to innovate by the U.S. cases, where plaintiffs alleged that the defendants breached the antitrust laws by innovating and thus, injuring the smaller non-innovative firms.¹⁰⁴ Indeed,

102 HOVENKAMP, *supra*, note 53 at 23.

103 SCHUMPETER, *supra*, note 27 at 81.

104 See, for example, Berkey Photo, Inc. v Eastman Kodak Co., 603 F. 2d 263 (2d Cir. 1979), cert. denied, 444 U.S. 1093; California Computer Prods., Inc. v IBM Corp., 613 F. 2d 727 (9th Cir. 1979); In re IBM Peripheral EDP Devices Antitrust Litigation, 481 F. Supp. 965, 1002-1008 (N.D. Cal. 1979), aff'd sub nom. Transamerica Computer Corp. v IBM Corp., 698 F. 2d 1377 (9th Cir.), cert. denied, 464 U.S. 955 (1983); ILC Peripherals Leasing Corp. v IBM Corp., 458 F. Supp. 423 (N.D. Cal. 1978), aff'd sub nom. Memorex Corp. v IBM Corp., 636 F. 2d 1188 (9th Cir. 1980), cert denied, 452 U.S. 972 (1981).

Professors Jansuz Ordovery and Robert Willig have developed a model of predatory product innovation.¹⁰⁵ Other commentators have argued that unduly restrictive U.S. antitrust policies have contributed to the ability of Japanese (particularly) and European companies to take the lead in pursuing a variety of critical technologies.¹⁰⁶

Thus, Professors Thomas Jorde and David Teece argue, rather than allowing numerous small firms to encourage innovation, antitrust policy should err on the side of preserving incentives to innovate by taking a tolerant view of single-firm conduct designed to enable companies to appropriate the returns to their innovative activity.¹⁰⁷

Third, history teaches that firms that do not innovate die. Leaner and hungrier small firms will destroy them. For example, American Viscose had 100 per cent of the U.S. rayon market in 1920 when its patent expired. In 1929 it had 50 per cent. Today it no longer exists.¹⁰⁸

The idea that numerous firms result in greater dynamic efficiency rests on an unprovable assumption. It is also highly controversial. No one has yet developed a rigorous economic theory of optimal production of innovation and a generally accepted connection between structure, number of firms and

105 Ordovery & Willig, An Economic Definition of Predation : Pricing and Product Innovation, 91 YALE L.J., 8 (1981).

106 L. THUROW, THE ZERO-SUM SOCIETY 3-25, 146-50 (1980); Baldridge, Luncheon Address, 53 ANTITRUST L.J. 397 (1984).

107 Jorde & Teece, Innovation, Cooperation and Antitrust, 4 HIGH TECH. L.J. 1 (1989).

108 J. MARKHAM, COMPETITION IN THE RAYON INDUSTRY 46-47 (1952).

innovation.¹⁰⁹ To base antitrust policy on an unverifiable theory would cause considerable harm. Thus, one should ignore it. On the other hand, the static model is predictable. The dynamic model is not. To use the dynamic model is, ultimately, to eschew the relevance of economics to antitrust. No one in any school of antitrust analysis, apart from the static model, argues this is a good thing.

Bernard Hill and Thomas Weston appear to argue that simply being concerned with efficiency is outdated.¹¹⁰ They base this on the U.S. Supreme Court's decision in Eastman Kodak Co. v Image Technical Services, Inc.¹¹¹ Kodak manufactured high-volume photocopiers and micrographic equipment. It refused to sell or allow the sale of spare parts to owners of Kodak machines except on the condition the purchaser accepted service from Kodak. This excluded independent service organisations from the market. They sued alleging an illegal tie-in-sale. Kodak moved for summary judgment, arguing it lacked market power in the spare parts market.¹¹² The Supreme Court held there

109. Posner admits that: "... as a matter of common sense, one might believe that innovation is increased by having more firms". However, he is unpersuaded because of the lack of economic proof. Ross, Interview with Judge Richard Posner, ANTITRUST, 4, 7 (Spring 1992).

110. Hill & Weston, Monopolisation and Telecommunications Markets in New Zealand, 15, unpublished seminar paper (1993).

111. S. Ct. 2072 (1992) (Scalia, O'Connor and Thomas J.J. dissenting).

112. Weston & Hill are incorrect in saying Kodak sought to strike out an antitrust claim. *Supra*, note 110, at 15. U.S. Summary Judgment is not an attempt to strike out a claim. It is a seeking of judgment by the court on limited discovery and without a trial. In essence, an applicant claims it does not need to call evidence, either because the facts are undisputed or the respondent's case

was sufficient evidence not to grant summary judgment. It remanded the case for trial. One of the main reasons was that the independent service organisations presented an economic model which showed Kodak's tie-in could harm consumers. Thus, the Court decided the case on efficiency. It did not mention non-efficiency, political reasons. There was evidence that Kodak's practice led to higher prices. Although, some commentators claim the decision is the death of the Chicago School and efficiency, they are being premature.¹¹³ There is no guarantee the independent service organisations will win at full trial. That Kodak could ask for summary judgment is a tying case is a victory for Chicago. Previous case law held tie-ins were per se illegal, irrespective of market power.¹¹⁴ Indeed, the case is really just about tying. It does not sound the death knell for Chicago and efficiency. The very next term the Supreme Court held predatory pricing is irrational and unlikely to occur.¹¹⁵ It quoted Robert Bork and Frank Easterbrook. Rather, than playing the death march for the Chicago School, one should play U.2's "Alive and Kicking". Indeed, Professor Stephen Calkins writes:

has no economic foundation. See, Schwarzer & Hirsh, Summary Judgment After Eastman Kodak, 61 HASTINGS L.J., 1 (1993).

113 See, e.g. Lande, Chicago takes it on the Chin: Imperfect Information could play a crucial role in the post-Kodak World, 62 ANTITRUST L.J., 193 (1993); Spivack & Ellis, Kodak: Enlightened Antitrust Analysis and Traditional Tying Law, 62 ANTITRUST L.J., 203 (1993).

114 International Salt Co. v U.S., 332 U.S. 392 (1947).

115 Brooke Group Ltd v Brown and Williamson Tobacco Corp., 113 S. Ct. 2578 (1993); The Court confirmed its decision in Matsushita Electrical Industries Co. v Zenith Radio Corp., 475 U.S. 574 (1986).

"Brooke Group serves as a rejoinder to commentators who thought Kodak marked the end of Chicago-School dominance of the Supreme Court and the dawning of the "post-Chicago" era. If Brooke Group is any indication, the Court is firmly in the Chicago School".¹¹⁶

My final assumption is that firms act as profit maximisers. They aim to achieve the maximum revenue possible. This too, is controversial but all the economic models depend on it.¹¹⁷

116 Calkins, The October 1992 Supreme Court Term and Antitrust More Objectivity than Ever, 62 ANTITRUST L. J., 327, 394 (1992).

117 Holmstrom argues firms may have other objectives such as revenue maximisation, sales maximisation or satisficing. Holmstrom, HANDBOOK OF INDUSTRIAL ORGANISATION, Chapter 9 (R. Schmalensee and R. Willig eds. 1989). The weaknesses in this argument are that we live in the age of corporate raiders. If a firm does not profit maximise a raider will take it over.

CHAPTER II

NONPRICE PREDATION

As mentioned in Chapter I, predation takes two forms Price or Nonprice.¹ Both forms operate on the principle that a firm with market power can act in such a way to increase its market power. However, a firm can achieve that result by simply acting in a normal competitive manner. Antitrust should value and encourage it. On the other hand some actions will be anticompetitive. This is predation. A firm can act anticompetitively on three interrelated ways. First - it can act so as to deter potential entrants. This may not harm the firm's existing rivals. Second - it can act so as to disadvantage rivals without necessarily causing them to exit. Third - it can actually cause existing rival(s) to leave. They will seriously deter potential rivals. All three categories of conduct can disadvantage potential and actual rivals.

Nonprice predation involves a predator acting so as to raise its rivals' or potential rivals' costs.² This forces the rivals to raise their price. Such action enables the predator to do likewise and market a profit. Under certain

1 Supra, Chapter I, at note 23.

2 Krattenmaker & Salop, Anticompetitive Exclusion : Raising Rivals' Costs to Achieve Power Over Price, 96 YALE L.J., 209 (1986); Krattenmaker & Salop, Exclusion and Antitrust, 11 Regulation, 29 (1987); Krattenmaker & Salop, Competition and Co-operation in the Market for Exclusionary Rights, 76 AM. ECON. REV., 109 (1986); Krattenmaker & Salop, Analysing Anticompetitive Exclusion, 56 ANTITRUST L.J., 71 (1987); Salop & Scheffman, Cost Raising Strategies, 36 J. INDUS. ECON. 19 (1987); Ordover, Saloner & Salop, Equilibrium Vertical Foreclosure, 80 AM. ECON. REV., 127 (1990).

circumstances the predator can gain "exclusionary market" power and thus indirectly power over price. This creates inefficiencies and reduces consumer welfare. Until recently commentators and courts have focused mainly on price predation. This is changing as scholars, enforcement agencies and private plaintiffs realise that nonprice predation is a more attractive strategy and thus more likely to occur.³

It is a form of strategic behaviour. The theory works as follows: the predator raises its victims' costs by any number of a variety of means. These include increasing the price of a critical input of its victims, by gaining exclusive control of the input or limiting access to it. The predator can do so by exclusive dealing, exclusive licensing, tying, refusing to deal, overbuying and vertical mergers. The predator can also raise costs by product promotion, brand proliferation, product differentiation, capacity expansion, innovation, burning down a rival's plant or cutting transmission lines.⁴ This causes the victim to decrease its output. The predator raises the victim's costs above market price, so making its business unprofitable.⁵

3 Calvani & Averitt, *Nonprice Predation : An Introduction*, 16 J. REPRINTS FOR ANTITRUST L. & ECON., No. 2 (1986); ABA ANTITRUST SECTION: MONOGRAPH NO. 18, *NONPRICE PREDATION UNDER SECTION 2 OF THE SHERMAN ACT* (1992).

4 Easterbrook, *Predatory Strategies and Counterstrategies*, 48 U. CHI. L. REV. 263 (1981); Tharp, *Raising Rivals' Costs : Of Bottlenecks, Bottled Wine, and Bottled Soda*, 84 NW. U.L. REV. 321 (1989).

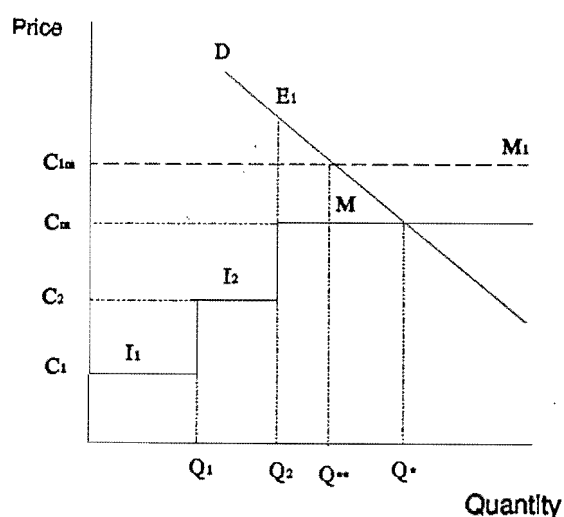
5 Salop, *Strategy, Predation and Antitrust Analysis : An Introduction*, 17 J. REPRINTS FOR ANTITRUST L. & ECON., No. 2 (1987); Salop, *New Economic Theories of Anticompetitive Exclusion*, 56 ANTITRUST L. J., 57 (1987).

The tactic can succeed even if the predator does not eliminate its rival.⁶ Generally, a firm's output decreases when its marginal cost increases. If a predator increases the marginal costs of all or most of its rivals, the decrease of the rival's supply will decrease, thus raising the market price. This gives the predator three choices. It could

- a) keep its output consistent and thus enjoy a higher market price.
- b) Expand its output to make up for the rival's decreased output and thus, enjoy a greater market share of the market at the original market price.
- c) Make up some, but not all, of the rival's reduced output and thus, enjoy a greater share of a somewhat smaller market, at a somewhat increased price.

One can graphically demonstrate the theory as follows:⁷

Graph 2



6 ABA Monograph, supra, note 2, at 9.

7 This derives from Scheffman, The Application of Raising Rivals' Costs Theory to Antitrust, 37 ANTITRUST BULL., 187, 191 (1992).

Graph 2 shows a competitive industry with a supply curve made up of three line segments, I_1 , I_2 and M and demand curve D . I_1 is the supply curve for producers that have constant average marginal costs of C_1 to an output of Q_1 . This is the absolute capacity limit for I_1 producers. I_2 is the supply curve for producers which have constant average and marginal costs of C_2 up to an absolute capacity level of $Q_2 - Q_1$. M is the supply curve of producers which have constant average and marginal costs of C_m . M producers have no capacity limitations. The competitive price is C_m and the competitive output is Q^* . At price C_m , the I_1 and I_2 producers are infra-marginal, i.e. although acting competitively, price is above their average costs. Now assume an episode of RRC raised the unit costs of the M producers to C_1^m , but left the unit costs of the I_1 and I_2 producers unchanged. This shifts M producers' supply curve up to M^1 - resulting in an increase in the market price to C_1^m and a decrease in industry output to Q^{**} .

This shows that prices in competitive markets are determined by industry marginal costs (and demand), so that prices increase with increases in industry marginal costs, so long as demand is not highly elastic. An increase in the I_1 or I_2 producers' costs will not raise industry marginal costs and price, unless the cost increase made their unit costs greater than C_1^m . Thus, raising a rival's costs does not necessarily raise industry marginal cost and price. Only cost increases that raise industry marginal costs, translate into price increases. The I_1 and I_2 producers' outputs do not increase as a result of the increases in M producers' costs. The I_1 and I_2 producers remain producing at their capacity and their share of the reduced industry sales increases because of the decrease in the M

producers' sales. Thus, as with predatory pricing, RRC results in an increased market share for the predator. Unlike predatory pricing, the RRC predator does not have to be able to eventually raise the market price by restricting its own input. The increase in price arising from a RRC strategy results from a restriction in the victim's output which occurs when the victim reacts to the increase in costs.

The above example shows a predator using RRC to raise the market price. A predator can use it to prevent price from falling. For example, the development of new products or technology may threaten a current producer. The new product or technology would decrease the demand for the current producer's product, thereby effectively lowering the market price for their product. An RRC strategy would involve raising the costs of reaching the market for the new product or technology thus, stabilising price.

A predator could do so by filing judicial, administrative or Resource Management proceedings to prevent, delay or raise the costs of the new product or technology entering the market.⁸ It could increase advertising which forces the new firm to match or exceed it. It could lobby government or regulatory agencies to establish a mandatory product standard. It could attempt to secure an increase in industry wide wage increase through negotiations with unions.⁹

An example is Allied Tube, Inc. & Conduit Corp. v Indian Head Inc.¹⁰

8 Scott, Abuse of Judicial and Administrative Processes - An Antitrust Violation?, 21 ABLR, 389 (1993).

9 Williamson, Wage Rates as a Barrier to Entry : The Pennington Case in Perspective, 82 Q. J. ECON., 85, 90-101 (1968).

10 108 S. Ct. 1, 931 (1988); Scheffman, *supra*, note 7, at 194.

The plaintiff manufactured plastic electrical conduit which was cheaper than the metal electrical conduit the defendants produced. The plaintiffs alleged the defendants manipulated the National Fire Protection Association standard for electrical conduit to decrease the use of the cheaper plastic conduit. Returning to Graph 2. The Demand Curve is the demand for conduit where metal and plastic are perfect substitutes. Assume the plaintiff had just invented plastic conduit. The preplastic market would consist of M producers (i.e. no I_1 or I_2 producers). If one assumes plastic conduit producers face no capacity constraints, plastic conduit will gain all the sales for which plastic and metal are good substitutes. Market price will be C_2 . Metal conduit producers will lose Q^* in sales.

Metal conduit producers thus have the incentive to prevent plastic conduit entering the market. If the National Fire Protection Association needs to certify that plastic conduit meets the required standard to sell, the metal conduit producers will benefit, if they can manipulate the standard to discourage use of plastic conduit. If the manipulated standard prevents plastic conduit entering, the metal conduit producers could prevent their price and market share from falling.

Thus, because nonprice predation can lead to market prices raising or staying stable where they would otherwise fall, it merits antitrust concern.

It especially merits concern as it is a more plausible strategy than price predation and thus more likely to occur.

Price Predation (or Predatory Pricing as it is better known as) involves a predator selling its product at a loss so as to drive its rivals from the market.

The predator then increases prices to recoup its losses and reap monopoly profits.¹¹ To succeed predator pricing requires certain conditions. A predator must be able to eliminate its victims quickly. Selling below cost is expensive. Not even the most well financed predator can sell below cost indefinitely. Predatory pricing is necessarily a temporary tactic.¹² The victim must not have counterstrategies which enable it to survive the predatory pricing.¹³ Conditions of entry and re-entry into the market must be high as once the predator has eliminated its victim and started monopoly pricing, new entrants cannot be able to enter quickly. Monopoly pricing plus the victim's salvage assets at distress prices, resulting from successful predation will attract new entrants.¹⁴ Consumer demand must generally be somewhat inelastic.

Some Chicago School scholars¹⁵ and indeed the United States Supreme Court¹⁶ have been extremely sceptical as to whether predatory pricing actually

11 Hay, Predatory Pricing, 58 ANTITRUST L. J., 913 (1990); Elzinga & Mills, Testing for Predation : Is Recoupment Feasible?, 34 ANTITRUST BULL. 869 (1989).

12 R. BORK, THE ANTITRUST PARADOX : A POLICY AT WAR WITH ITSELF 149-155 (2d ed. 1993).

13 Easterbrook, *supra*, note 4.

14 *Id.* at 279.

15 BORK, *supra*, note 12, at 149-155; Easterbrook, *supra* note 4; McGee, Predatory Price Cutting : The Standard Oil (N.J.) Case, 1 J.L. & ECON. 137 (1968); Telser, Cutthroat Competition and the Long Purse, 99 J.L. & ECON., 259 (1966).

16 Matsushita Electrical Industries Co. v Zenith Radio Corp., 475 U.S. 574 (1986); Brooke Group Ltd v Brown and Williamson Tobacco Corp., 113 S. Ct. 2578 (1993); For a summary of authority on U.S. predatory pricing see Austin, Predatory Pricing Law Since Matsushita, 58 ANTITRUST L. J. 895 (1990).

exists. They argue it is not rational behaviour for a dominant firm. In theory, predatory pricing requires the predator to incur losses that are much larger than those it inflicts on its victims. As the predator already has a proportionately larger market share, it will incur proportionately larger losses because of its predation. The longer the predation lasts, the larger the losses for the victim. These scholars also argue the strategy is extremely speculative.¹⁷ The predator expects to recoup its losses by monopoly pricing once it has eliminated its victim. As those anticipated profits are future and uncertain, they must be discounted in value. Another problem, is that once the predator has eliminated its victim, the predator's monopoly pricing and victim's assets at salvage price will attract new entry. This may well occur before the predator has recouped its losses. The predator's anticipated monopoly profits are uncertain and speculative. Judge Frank Easterbrook notes that the victim may have counterstrategies to enable it to survive the predatory pricing which must necessarily be temporary.¹⁸ These counterstrategies include entering into long term contracts with its customers, obtaining financing to endure the predatory pricing or cutting production or even ceasing business until prices rise again.¹⁹

This view of predatory pricing is not unanimous. Professor George Hay has written "Among economists, however, it is generally agreed that the argument that [price] predation is impossible is incorrect, at least as a matter of

17 See, *supra*, note 15.

18 Easterbrook, *supra*, note 4.

19 *Ibid* at 289.

economic theory".²⁰

Professor John Baker argues that predatory pricing can be a successful strategy to "discipline" a market.²¹ He bases this on the work of Judge Richard Posner,²² Professor Oliver Williamson²³ and Professor Frederic Scherer.²⁴ These commentators base their theory on imperfect information which exists in multi-market firms. They argue that a firm's reputation for predation if credible can deter entry into markets, beside those in which the actual predation occurs.²⁵ A victim of predation in one market, can be a chilling example to prospective entrants and challengers in all the predator's market. Reputation can spread to different geographic markets, different product markets and later time periods. For example, if a firm is deciding which of two markets to enter, and the dominant firm in one has a credible reputation for predation the entrant may well decide to enter the other market. The entrant will know that predatory battles are expensive and that it is not worth going to war. Thus, a single

20 Hay, *supra*, note 11, at 913.

21 Baker, Recent Developments in Economics that Challenge Chicago School Views, 58 ANTITRUST L. J., 645, 648-649 (1989), (predatory pricing can be a successful strategy to discipline a market).

22 R. POSNER, ANTITRUST LAW : AN ECONOMIC PERSPECTIVE 191-193.

23 Williamson, Predatory Pricing : A Strategic and Welfare Analysis, 87 YALE L. J. 284 (1977).

24 Scherer, Predatory Pricing and the Sherman Act: A Comment, 89 HARV. L. REV. 869 (1976); Scherer, Some Last Words on Predatory Pricing, 89 HARV. L. REV. (901) (1976).

25 POSNER, *supra*, note 22 at 184-187. SCHERER, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE 599-560 (2d ed. 1980).

predatory incident may give a double benefit : even if predation in one market may not pay acceptable returns from that market alone, the effects of a general reputation for toughness may provide ample benefits across several markets.²⁶

Other commentators have developed signalling theories of predatory pricing. Here, the predator's motive is to induce exit rather than deter entry. The predator by cutting price falsely signals a cost advantage. That causes the victim to leave the market and also may persuade potential entrants not to enter.²⁷ These models all depend on game theory.²⁸ While they are economically sound they are difficult for courts to implement.²⁹

Whatever one's view of price predation, nonprice predation is a more attractive, plausible and rational strategy.

Nonprice predation does not involve the predator suffering significant short term losses in the hope of gaining long term speculative and indeterminate profits. It is far cheaper for the predator than price predator. The strategy may inflict losses on the predator. These are likely to be small in comparison to the costs the victim must face. This is especially so, where a predator misuses judicial and administrative processes to raise rivals' costs.³⁰ Predators may be able to join forces and share costs. A predator may also be able to persuade a

26 Fudenberg & Tirole, A Signal-Jamming Theory of Predation, 17 RAND J. ECON. 366 (Autumn 1986).

27 *Id.*, at 372.

28 See, Fisher, Games Economists Play : A Non-cooperative View, 20 RAND J. ECON. 113 (Spring 1989).

29 *Id.*, at 117; Hay, *supra*, note 11.

30 Scott, *supra*, note 8, at 391.

third party, such as the Commerce Commission, to bear the costs.³¹

The success of the strategy does not depend on the predator eliminating its rivals. A higher cost rival has to reduce output, allowing the predator to raise price or market share immediately. Thus, unlike price predation, a nonprice predator does not have an extended waiting period or the uncertainty involved in price predation.³² In any event, a firm would prefer to compete against high cost rivals rather than low cost rivals.

Nonprice predation has fewer legal risks than price predation. As mentioned above, a predator can use a wide range of mechanisms to raise rivals' costs. These include normal business arrangements. Thus, the predator's anticompetitive purpose may be harder to detect and prove. This will especially be so with alleged misuse of judicial and administrative processes.

A predator can use nonprice predation in a wide variety of circumstances. As it is cheaper than price predation, it can be effective in a large number of markets. A predator can, in some circumstances, permanently raise rivals' costs. For example, by obtaining an injunction or regulatory protection such as a mandatory product standard.

However, as with predatory pricing, nonprice predation will be ineffective if market entry is easy. If supracompetitive prices induce entry, the predator cannot expect to earn long term supracompetitive profits. But, as mentioned above, the predator can use nonprice predation against prospective entrants.

31

32 Salop, Strategy, Predation and Antitrust Analysis : An Introduction, 17 J. REPRINTS FOR ANTITRUST L. ECON., No. 2, at 13-15 (1987).

This may prevent or deter entry. Even if entry occurs, it will disadvantage the entrants. Thus, a predator has every incentive to raise rivals' costs. It is a plausible and rational strategy. Antitrust law should prohibit it.

In imposing liability for nonprice predation one must be careful. Not all conduct which raises rivals' costs is anticompetitive. It may be extremely procompetitive. For example, Fisher and Paykel may develop a wonder oven which enables duffers to cook meals worthy of Anton Mosimann. This will inevitably raise the costs of rival manufacturers who will have to spend significant amounts to develop a similar oven. They will probably also have to undertake extensive advertising and distribution programmes to sell their now outdated models. The new oven would give Fisher and Paykel power over price in the sense it could sell the oven above marginal costs. Not even an antitrust law would condemn this behaviour despite it having raised rivals' costs.

Much normal competitive behaviour will raise rivals' costs. For example, bidding for the services of a key employee will inevitably raise the costs of a rival who also wants the employee.³³ Normal advertising will cause rivals to spend more on their own advertising to maintain sales, thus increasing costs. Normal price cutting will often require rivals to spend more on product improvements to increase sales. Property rights, in all forms, tend to raise the costs of those who do not own the property. As Professor Wesley Liebeler notes: "General Motors presumably increases Ford's costs by denying it the use of General

33 ABA Monograph, *supra*, note 2, at 8-10.

Motor's plant".³⁴ Antitrust law cannot condemn the above behaviour.

Similarly, a dominant firm may use litigation to raise rivals' costs. The mere fact that the litigation raises costs is not enough to make it anticompetitive. Dominant firms must be able to go to court.

Normal rivalry demands that a firm keep its costs low. One way of doing this, is to acquire exclusive commitments from the lowest-cost suppliers. By excluding rivals from these suppliers, the firm has raised rivals' costs. In certain, but not all, circumstances this merits antitrust concern. To condemn such behaviour for simply raising rivals' costs would be to condemn normal business behaviour. It would also ignore the efficiency enhancing benefits of actions that raise rivals' costs.

Thus, before imposing liability for raising rivals' costs, certain criteria must be met. Any model which condemns raising rivals' costs must distinguish between normal behaviour that unobjectionably raises rivals' costs and behaviour which antitrust should outlaw. It must explain how a predator raises rivals' costs. It must only impose liability when rivals' costs are raised for a significant time. The model should take account of any efficiency explanation for actions that raise rivals' costs. In short, it must only condemn predators' actions which raise rivals' costs where those actions harm competition, not simply competitors.

Commentators have developed such models. Professor Thomas Campbell has developed a model of spatial oligopoly.³⁵ Professors Janusz Ordover and

34 Liebler, Exclusion and Efficiency, AEI REG. J., 34, 38 (Nos. 3 & 4 1987).

35 Campbell, Predation and Competition in Antitrust : The Case of Nonfungible Goods, 87 COLUMB. L. REV., 1625 (1987).

Robert Willig have developed a theory of predatory product innovation.³⁶ However, I will only deal with Professors Thomas Krattenmaker and Steven Salop's model of Raising Rivals' Costs (RRC).³⁷ They claim it meets the above criteria.

36 Ordoover & Willig, An Economic Definition of Predation : Pricing and Product Innovation, 91 YALE L.J. 8 (1981).

37 See, generally Krattenmaker & Salop, Anticompetitive Exclusion : Rising Rivals' Costs to Achieve Power Over Price, 96 YALE L.J. 209 (1986).

CHAPTER III

THE RAISING RIVALS' COSTS MODEL

Professors Thomas Krattenmaker and Steven Salop, in a seminal Yale Law Journal article, developed a model of Raising Rivals' Costs (RRC) for courts to use.¹ They developed earlier work of Salop and Professor David Scheffmann who argued a firm could more effectively and credibly prey on rivals by raising their costs, than by predatory pricing.² Krattenmaker and Salop argue that courts should analyse virtually all types of exclusionary (predatory) conduct using a RRC concept.³ They argue that U.S. courts' traditional analysis of tying arrangements, exclusive dealing, refusals to deal, group boycotts, vertical mergers and other exclusionary activities is economically incoherent and in disarray.⁴ They argue that a lack of a coherent economic model of anticompetitive exclusion has prevented the courts from developing sound legal rules.⁵ The existing legal rules do not enable courts to distinguish between predation and vigorous competition. They give the example of the United States Supreme

1 Krattenmaker & Salop, Anticompetitive Exclusion : Rising Rivals' Costs to Achieve Power Over Price, 96 YALE L. J. 209 (1986).

2 Salop & Scheffman, Raising Rivals' Costs, 73 AM. ECON. REV. 267, 268 (1983) ("These elements combine to make cost-increasing strategies more credible than predatory pricing").

3 Krattenmaker & Salop, *supra*, note 1, at 211.

4 *Id.* at 222.

5 *Ibid.*

Court in Standard Oil Co. of California v U.S.⁶ Here, a majority of the Supreme Court held that Standard Oil's exclusive dealing contracts with petrol stations breached the antitrust laws because they involved a substantial portion of commerce and they right therefore foreclose competing suppliers. The court emphasised a plaintiff need not show "that competitive activity has actually diminished or probably will diminish".⁷ Krattenmaker and Salop note Standard Oil had not prevented competing suppliers from attracting petrol stations by offering them better terms. Unless Standard Oil contracted with so many petrol stations that it gained monopoly power in petrol selling, it could only gain from exclusive dealing if it was more efficient than alternative distribution methods. Krattenmaker and Salop conclude the court held the only possible antitrust concern (the impact on competition) was irrelevant, ignored a procompetitive reason for the exclusive dealing (efficiency) and focused on a competitively neutral fact (the substantial amount of commerce involved).⁸

They argue this is a result of the inherent weakness of the traditional model of foreclosure. According to this model, a firm that contracts with a supplier for its requirements of inputs, forecloses its rivals from the inputs it purchases. Since supply decreases, price increases.

One can graphically show the argument.⁹

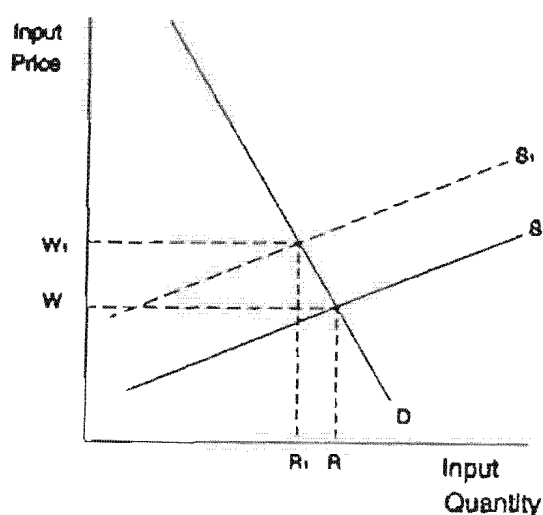
6 337 U.S. 293.

7 Id. at 318.

8

9 This is taken from, Krattenmaker & Salop, *supra*, note 1, at 232.

Graph 3



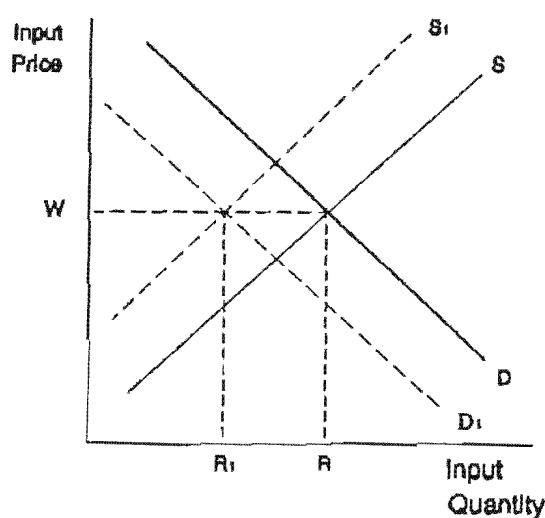
Assume this involves an exclusive dealing agreement between Input Seller A and Buyer B. The contract denies A's production to B's rivals. Before the contract B and its rivals pay price W for the input which A and its rivals supply. Price W is determined by the interaction of the buyer's demand (D) and the seller's supply (S).

After the contract A's inputs are no longer available. This decrease in supply (S^1) drives the price to B's rivals to the higher price W^1 .

The flaw in this argument, is that price does not increase. The reduction in available supply is exactly offset by the reduction in demand that is satisfied by the contractual purchases. Graphically this goes as follows:¹⁰

¹⁰ Id, at 233.

Graph 4



If A's inputs are no longer available to B's rivals, B will no longer be adding to the demand for inputs from A's rivals. The exclusive dealing contract simply realigns purchase patterns. In graph 4 the price remains the same, as the loss of A's supply (shift from S to S^1) is cancelled by the loss of B's demand (shift from D to D^1). The only effect, is to remove from the market an amount of Inputs ($R - R^1$), equivalent to the amount A supplies to B. This has probably no anticompetitive effect.

This discredited theory has prevented courts developing coherent rules. It led Krattenmaker and Salop to develop their RRC model. They argue that RRC provides the proper underpinning for analysing all the various, potentially, predatory practices. They argue courts should analyse all the practices using the one model, RRC. This involves courts applying a two stage analysis. This analysis will permit courts to devise rules that allow competition which benefits consumers, while deterring strategic behaviour which harms consumers. First,

one asks does the conduct unavoidably and significantly raise rivals' costs.

Second, if so, do the rivals' raised costs allow the predator to exercise market power, i.e. raise prices above the competitive level.¹¹ Thus, the model inquires not only into injury to competitors (first step), but also into injury to competition (second step).

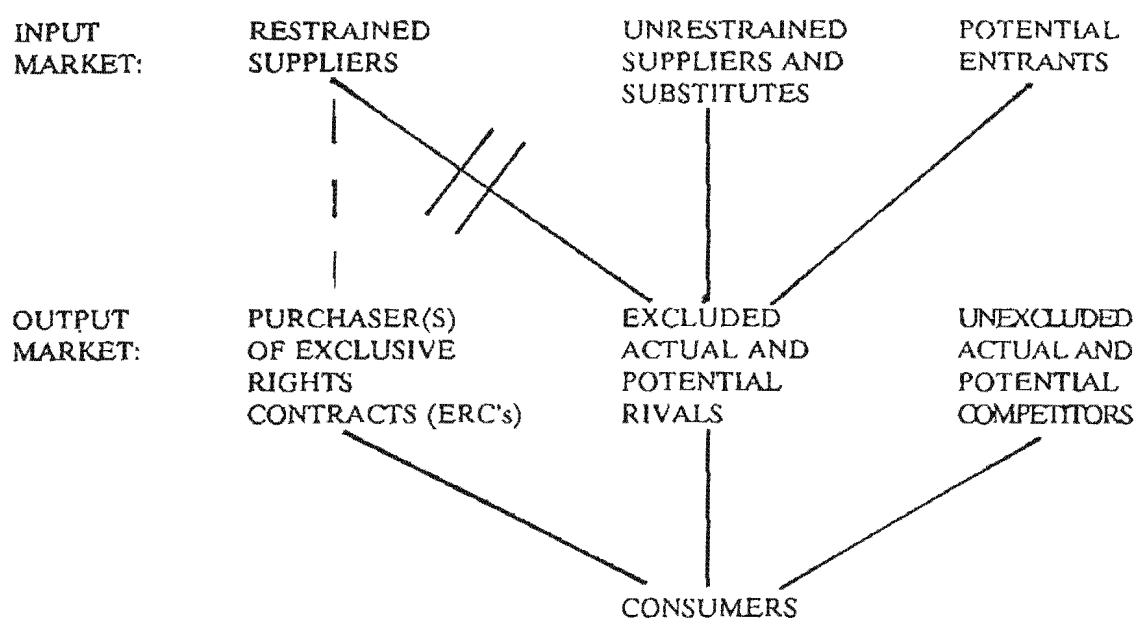
Krattenmaker and Salop say courts should view all types of exclusionary conduct as means of purchasing exclusionary rights (ER). An ER is the right to exclude rivals from equal access to inputs to the production or marketing processes. For example, under an exclusive dealing agreement, a retailer that contracts to be the exclusive outlet for a manufacturer, has purchased the right to exclude competing retailers. When a particular retailer agrees to carry only one manufacturer's product, that manufacturer has purchased the right to exclude competing manufacturers. Thus, the purchaser of the ER may be the buyer or seller in the underlying transaction.

The model requires analysis of two markets. First, the input market. One must examine this to determine if the predator's purchase of ER will significantly raise rivals' costs.

Second, one must examine the output market to determine where the rivals' raised costs enable the predator to raise or maintain its price above the competitive level.

The analytic framework is shown in figure 1.

11 Id, at 240.

FIGURE 1: BASIC ANALYTIC FRAMEWORK¹²

Here, the ERC has removed the restrained suppliers (ERC sellers) as a source of input to the rivals of the firm that purchased the exclusive rights. Whether this has significantly raised rivals' costs requires a court to consider: the cost and availability of the input from the unrestrained suppliers and potential entrants and the availability of substitute input products. A court, then considers how significant the input is in the rivals' overall cost structure. A court decides whether a rivals' costs have been significantly and substantially increased. It ignores those practices which only negligibly raise costs.

If a court decides that rivals' costs are substantially increased, it then examines the output market to determine whether the predator can price above the competitive level. To do this, a court considers the extent of competition

12 *Id.* at 226.

from: excluded and unexcluded actual and potential rivals and from the producers of substitute products.

The model postulates four ways in which the purchase of exclusive rights can raise costs.

1 Bottleneck.¹³

A predator can raise rivals' costs by purchasing rights to all or most of the supply of a critical production unit. If substitute units are more expensive, or less efficient, rivals will incur higher production costs. This gives rise to a "bottleneck" or an essential facilities case.¹⁴ Given that a rival has to buy more expensive substitutes, a court can directly measure the amount rivals' costs are raised.¹⁵

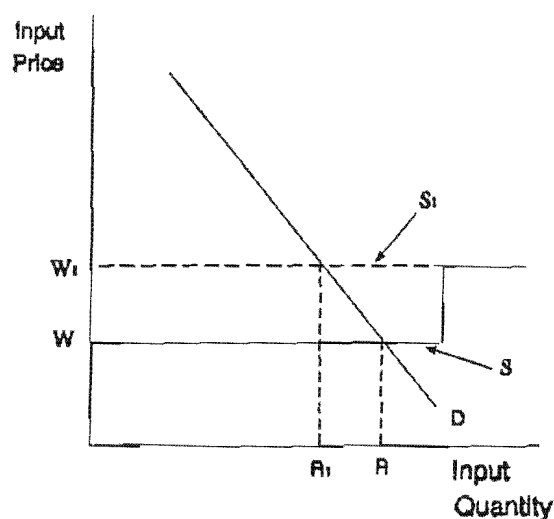
Graph 5 shows the Bottleneck scenario.

13 Id. at 234.

14 See, *infra*, Chapter VII.

15 Krattenmaker & Salop, *supra*, note 1, at 235.

Graph 5



Before the predator obtains exclusionary rights to an input, supply (S) and demand (D) give a price of W .

The predator's purchase of rights to exclude rivals from all the low-cost supply of the input reduces supply to S^1 . As only high cost sellers can meet the remaining rivals' demand (D), price increases to W^1 and quantity falls from R to R^1 .

A predator need not use the input itself. It may simply pay input suppliers not to supply its rivals. Krattenmaker and Salop give the example of U.S. v Aluminium Co. of America (Alcoa).¹⁶ Alcoa allegedly contracted with a number of electric utilities for the utilities not to provide power to rival aluminium producers. Alcoa did not buy power from the utilities. It bought the right to exclude its rivals from the electricity from the utilities. Krattenmaker and Salop term this a "naked" exclusionary right. Graph 5 shows this situation.

¹⁶ 44 F. Supp. 97, 122-141 (S.D.N.Y., 1941), *aff'd* in part and *rev'd* in part, 148 F. 2d 416 (2d Cir. 1945).

If the predator used the input, demand would shift back. The demand curve would shift to the left, but the input price would still rise to W^1 .

2 Real Foreclosure:¹⁷

A predator may foreclose its rivals' access to an input by purchasing such a large portion of the total supply that it forces rivals to bid up the price of the remaining supply. Commentators call this a "supply squeeze" or "quantitative foreclosure", because the emphasis is on the sheer amount of the input foreclosed.

A predator can limit supply by two ways:

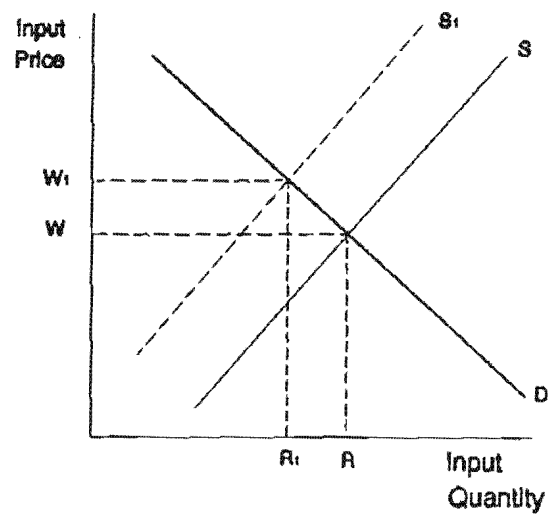
- a) obtaining an agreement from suppliers not to supply rivals (naked exclusion), or
- b) overbuying, i.e. buying more than it needs.

Graphically the two methods are as follows.¹⁸

Naked Exclusion:

¹⁷ Krattenmaker & Salop, *supra*, note 1, at 236.

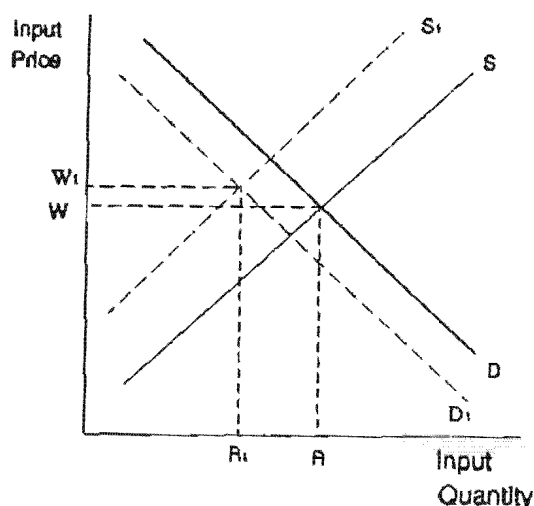
¹⁸ *Id.*, at 237.

Naked Exclusion:**Graph 6**

Before the predator obtains the naked exclusionary right, price is W (intersection of S and D). The naked exclusionary right reduces the supply available to rivals with no reduction in demand. Price increases to W^1 .

Overbuying:¹⁹

Graph 7



Before the overbuying, price is W (intersection of S and D). Overbuying in the market where the predator's rivals buy, removes more supply (shift in supply from S to S') than the predator absorbs for its own use (shift in demand from D to D'). Price, therefore, increases to W' (intersection of S' and D'). This is so, even though suppliers are sufficiently numerous that no single seller has market power.

The predator and its rivals both pay the higher price. However, the predator may still benefit, even though its own costs are raised. The rivals' cost increases may be larger, if the predator uses the input less intensively, if it is vertically integrated or protected by superior bargaining ability or a long term supply contract.

Krattenmaker and Salop distinguish the Real Foreclosure scenario from

19 Ibid.

limited availability of the input.²⁰ Bottleneck forces rivals to substitute for the desired input, whereas Real Foreclosure gives rivals the extra option of paying a higher price for the originally desired input.

However, this distinction does not seem valid. In both cases, the rivals pay higher prices to buy an input. Whether the input is the one originally desired or a substitute, the cost of production still increases. (In the latter case because the substitute is less efficient.) The nature of the input only affects the amount of the price increase. Thus, Bottleneck is just a special case of foreclosure.²¹

To assess the likely impact of Real Foreclosure on input price Krattenmaker and Salop suggest courts examine the "foreclosure ratio". This is the percentage of the market supply previously available to rivals, that the predator's exclusionary contracts have denied to them. The higher the foreclosure ratio, the greater the increase in rivals' costs. However, the actual cost increase depends on more than the foreclosure ratio. It depends on elasticity of demand, conditions in the output market and other factors.

20 Id, at 236.

21 Tharp, Raising Rivals' Costs : Of Bottlenecks, Bottled Wine, and Bottled Soda, 84 NW.U.L. REV., 321, 330 (1989).

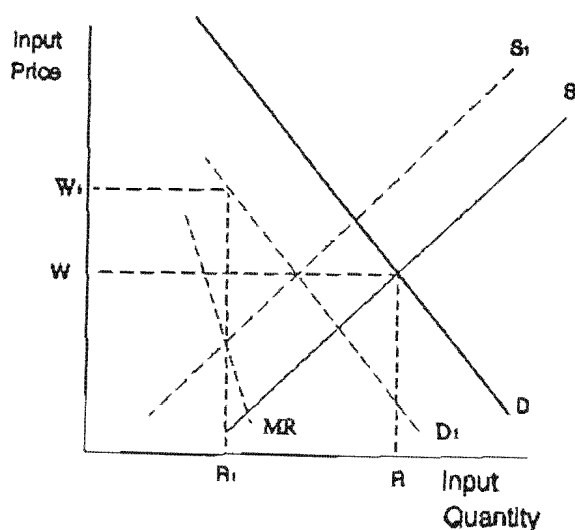
3 Cartel Ringmaster:²²

Some exclusionary rights may enable the predator to orchestrate cartel-like behaviour by its suppliers against its rivals. The suppliers will decrease the supply of an input - thus raising costs. The premise behind the scenario is that the predator may be better able to organise a cartel, than the suppliers themselves. If a market contains many suppliers, a large purchaser may be able to coordinate the suppliers against the purchaser's rivals.

Again there are two methods of achieving this scenario. Graphically one can show them as follows:

a) Purchase agreement:²³

Graph 8



Here, initially supply (S) and demand (D) give a price W and quantity R .

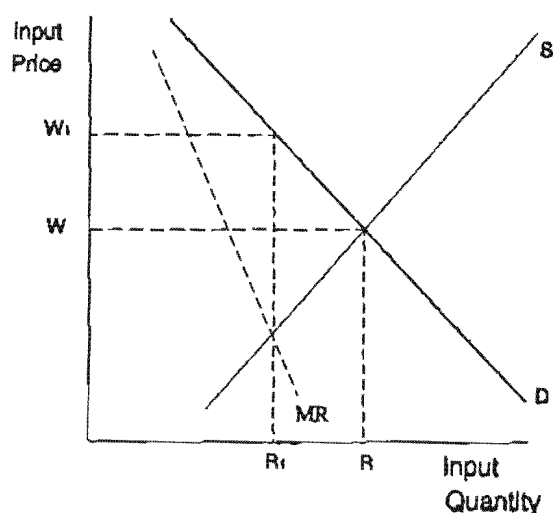
²² Krattenmaker & Salop, *supra*, note 1, at 238.

²³ *Id.*, at 239.

A vertical restraint (such as exclusive dealing) removes the predator's demand from the market. This shifts the demand D to D^1 . It causes a corresponding decrease in supply from S to S^1 . The vertical restraint directs suppliers to decrease or eliminate their competition in selling the remaining output to the predator's rivals. The suppliers can monopoly price, reducing output to point R^1 , where marginal revenue (MR) equals the cost of supply (S^1). This enables the suppliers to charge a higher price, W^1 .

b) Naked Exclusion:²⁴

Graph 9



This is similar to Graph 8, except it involves a naked exclusionary right. This means there is no change in the supply and demand curves - but price still increases.

The problem of cheating remains as with any cartel. Thus, Krattenmaker

and Salop borrow from the U.S. Department of Justice 1984 Antitrust Merger Guidelines to determine whether an effective cartel is possible in a particular fact situation. The Guidelines (and Krattenmaker and Salop) say an effective cartel is possible in the hypothetical market consisting only of restrained firms only if its HHI index exceeds 1000 or (1800).²⁵ If this is the case, a court should assess the effect of coordination among the restrained firms on the market as a whole, by treating the exclusionary contracts as a merger of all the restrained firms. Thus a court would compare the model's original HHI with the "postmerger" HHI in which a court would treat all the restrained firms as a single firm. The HHI calculations are not determinative by themselves. A court has to analyse several other factors - especially ease of entry.²⁶

4 Frankenstein Monster.²⁷

The predator by removing restrained suppliers from the market may leave a concentrated market of unrestrained suppliers. These remaining unrestrained suppliers may be able to collude and fix prices. This raises rivals' costs. The predator does not orchestrate the cartel. It creates an environment where the

25 U.S. Dept of Justice, Antitrust Div., 1984 Merger Guidelines, 49 Fed. Reg. 26, 283 (1984) (Merger Guidelines). The Merger Guidelines provide that a merger among nondominant rivals will be challenged where the postmerger HHI is over 1000 and the increase due to merger over 100, or where the post-merger HHI increased more than 50 to over 1800. Although Krattenmaker and Salop adopt the framework of the Merger Guidelines, their raising rivals' costs analysis can employ whatever technique of merger analysis the court favours. See Krattenmaker & Salop, *supra*, note 1, at 256 n. 146.

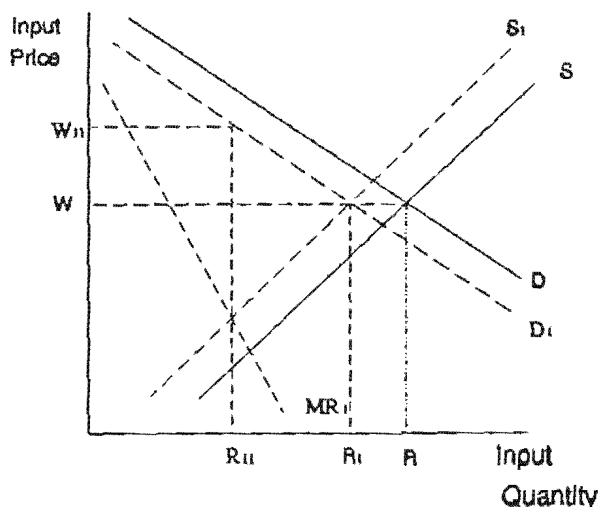
26 Krattenmaker & Salop, *supra*, note 1, at 256-257, 262.

27 *Id.* at 240.

unrestrained suppliers are likely to form and operate a cartel of their own accord.

One can show this graphically.²⁸

Graph 10



Before the restraint, supply (S) and demand (D) give a price W and quantity R . The restraint removes the predator's demand (shift from D to D') and the restrained supplier's supply (shift from S to S') from the market. This reduces total market sales to R' while price stays at W . If the predator creates a Frankenstein Monster, so that the remaining suppliers can collude and coordinate pricing they would only supply quantity R'' , i.e. where Marginal Revenue (MR') equals the cost of supply (S') giving a price of W'' . Again Krattenmaker and Salop borrow from the Merger Guidelines to assess whether a cartel is likely. The same analysis as for Cartel RingMaster, occurs with Frankenstein Monster.

Under the Cartel RingMaster and Frankenstein Monster scenarios, suppliers increase the price as an exercise of market power. Under Bottleneck and Real Foreclosure the predator's purchases cause the price of the input to rise, even though suppliers are sufficiently numerous that no single supplier can exercise market power.

STAGE TWO - MARKET POWER:

A predator attracts no antitrust liability if it simply raises rivals' costs by any of the above four techniques. The cost raising strategy must give the predator power to raise its own price above the competitive level. A court must assess whether the increase in cost of the input has any effect on the cost of the output.

Krattenmaker and Salop identify key structural requirements that must exist before the above four techniques give the purchaser of the ER power over price.²⁹

(1) The input market must be a significant portion of the final product. If not, an increase in the price of the input is unlikely to lead to an increase in the price of the final product. For example, a huge increase in the price of paper clips which General Motors purchase is not going to affect the price of cars, whereas a smaller increase in the price of sheet metal might.

(2) Competition from unexcluded rivals or potential entrants willing to supply additional quantities of their products cannot constrain the predator's power over price. It is not enough for a predator to raise the cost of a few of its rivals.

29 Id. at 242-247.

There still may be numerous unaffected rivals who prevent the predator pricing supracompetitively. For example, a farmer who increases the costs of ten of his rivals will be unable to exercise market power because he faces lots more competition. Krattenmaker and Salop borrow from the Merger Guidelines to assess the likely effects on the output market of the increase in rivals' output costs. They would compare the original HHI of the output market with the HHI of a postexclusionary market that omits all firms whose costs have been significantly increased.³⁰ They also argue courts should not separately analyse market power and the predator's conduct. If a predator, by raising rivals' costs, prevents prices from falling, when they otherwise would then that conduct is the primary focus of the analysis. A court cannot evaluate such conduct by itself. The conduct creates the market power - not the other way around. Similarly, market share is useful in the analysis. The bigger the difference in market share between the RRC predator and its victims, the bigger the profits for gaining a higher price for its output. Such a predator will want and be able to spend more on an RRC strategy. Thus, market share is a helpful indication - but it is not determinative by itself.

If barriers to entry are low, the predator will not be able to price supracompetitively, because supracompetative prices will attract new entry. Similarly, readily available substitutes cannot exist as these will prevent the predator pricing supracompetatively.

The second stage of the RRC model is to determine whether competition has been harmed in the output market. This is a test of market power.

30 Id. at 265-266.

Economists define market power as the ability of a firm or group of firms to price profitably above marginal cost.³¹ In less technical terms, it refers to the ability to price above competitive levels. United States antitrust law has distinguished between "market power" and "monopoly power". The Supreme Court has defined "market power" as "the ability to raise prices above those that would be charged in a competitive market".³² It has defined "monopoly power" as "the power to control prices or exclude competition".³³ Krattenmaker, Salop and Professor Robert Lande say this distinction must be eliminated for the purposes of the RRC model.³⁴ They would distinguish between two methods of exercising market power. First, a firm may increase price by decreasing its output - i.e. it may control price (classic market power). Chicago School commentators have usually focused on the ability of a firm to control price by restricting its own output.³⁵ Hence, Krattenmaker, Salop and Lande term this "classical" or "Stiglerian" market power.³⁶

31 See, for example, HOVENKAMP, *ECONOMICS AND FEDERAL ANTITRUST LAW* 55 (1985); POSNER, *supra*, *ANTITRUST LAW : AN ECONOMIC PERSPECTIVE* 242 (1976); POSNER & EASTERBROOK, *ANTITRUST : CASES, ECONOMIC NOTES AND OTHER MATERIALS* 34 (2d ed. 1981).

32 NCAA v Board of Regents of Oklahoma, 468 U.S. 85, 109 n. 38 (1984).

33 U.S. v E.I. du Pont de Nemours & Co., 351 U.S. 377, 391-392 (1956).

34 Krattenmaker, Lande & Salop, *Monopoly Power and Market Power in Antitrust Law*, 76 GEO. L. J., 241.

35 BORK, *THE ANTITRUST PARADOX : A POLICY AT WAR WITH ITSELF* 116-134 (2d ed. 1993); Hovenkamp, Antitrust Policy After Chicago, 84 MICH. L. REV., 213, 260-283.

36 Krattenmaker, Lande & Salop, *supra*, note 34, at 249. They term it "Stiglerian" as Professor George Stigler extensively analysed it in G. STIGLER, *THE ORGANISATION OF INDUSTRY* (1968).

Second, a firm may raise price above the competitive level or prevent it falling to a lower competitive level, by raising its rivals' costs and thus causing them to restrain their output. They term this "exclusionary" or "Bainian" market power.³⁷

Both practices lead to decreases in consumer welfare. Restricting output below the efficient competitive level denies consumers goods they value in excess of the marginal cost. Thus, allocative efficiency is reduced. Similarly they both transfer wealth from consumers to manufacturers.

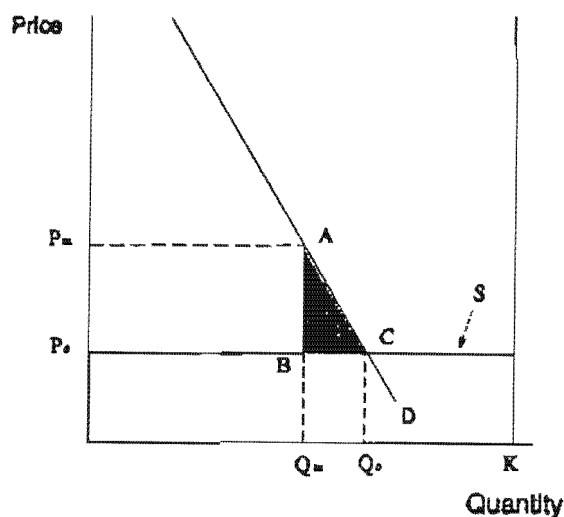
Bainian market power decreases production efficiency. The two types of market power can occur alone or together.

Stiglerian or classical market power can be shown graphically as follows:³⁸

37 Krattenmaker, Lande & Salop, *supra*, note 34, at 249. They term it "Bainian" as Professor Joe Bain extensively analysed the concept in J. BAIN, *INDUSTRIAL ORGANISATION* 324-330. Bork also recognised that a firm could gain market power by raising rivals' costs by disturbing optimal patterns of distribution; BORK, *supra*, note 35, at 156.

38 This is derived from Krattenmaker, Lande & Salop, *supra*, note 34, at 266.

Graph 11

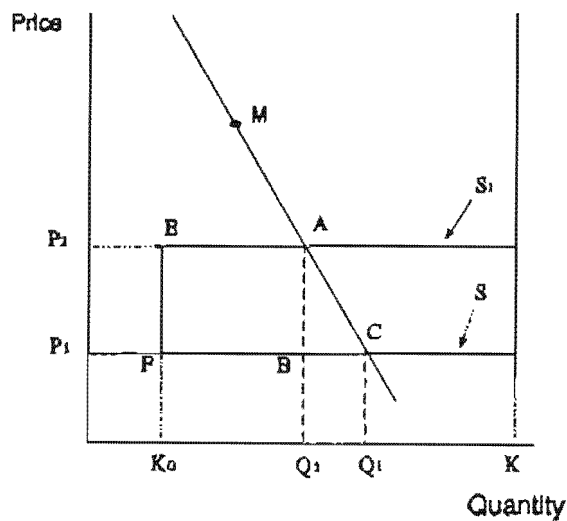


S is the marginal cost curve for a monopolist in an industry. D is the monopolists' demand curve. The monopolist has a constant marginal cost up to its production capacity, K. The monopolist does not produce the competitive amount Q_c at the competitive price, P_c , where price equals marginal cost. The monopolist sets a higher price, P_m , and decreases its output to Q_m , i.e. the point where marginal revenue equals marginal cost. The triangle ABC is the deadweight efficiency loss or the loss in consumer welfare. The rectangle P_m -A-B- P_c represents the transfer of wealth from the consumer to monopolist.

Bainian or exclusionary market power can be graphically shown as follows:³⁹

39 Id. at 268.

Graph 12



S is the competitive supply curve of a market which produces two separate products X and Y. These are the only substitutes for each other. KG is the total capacity of X producers. The total capacity of X producers and Y producers is K . The increase in the cost of X is shown by the upward shift in the supply curve from S to S^1 . Even if competition maintains a price where demand equals marginal cost, the price rises from P_1 to P_2 while quantity decreases from Q_1 to Q_2 .

The efficiency loss is not only, triangle ABC, but also the loss in production efficiency, i.e. the increased costs of producing the remaining output, shown by rectangle EABF.

Krattenmaker and Salop argue that classical market power does not explain RRC and the consumer welfare effects of RRC. If a predator can keep prices level when otherwise they would fall classical market power will not exist,

yet consumer welfare will suffer because the predator has power over price.⁴⁰

There are considerable consumer welfare effects if a predator has raised rivals' costs and consequently achieved the ability to price supracompetitively. If the predator can retain the ER that raises rivals' input costs, production inefficiency will result. The current suppliers of the input will have reduced their production of the input resulting in higher prices in the input market. If no alternative sources of supply are available, production of the needed input may be reduced with consequent higher prices and reductions in production efficiency. Resources previously used to make the needed input will be directed elsewhere, resulting in less than optimal allocation of production resources.⁴¹

Consumers of the ultimate product will pay higher prices. Some consumers will thus not buy the product and buy less satisfactory substitutes. Consumers that still buy the product will pay a higher price and hence, have less money to buy other inputs they might otherwise acquire.

Thus, a successful RRC strategy will result in inefficiencies in the allocation of resources at the production stage and inefficiencies in the allocation of resources at the consumption stage.⁴² This is why Krattenmaker and Salop argue market power is necessary for liability.

40 . Krattenmaker & Salop, *supra*, note 1 at 262-265.

41 ABA ANTITRUST SECTION ; MONOGRAPH NO. 18 NONPRICE PREDATION UNDER SECTION 2 OF THE SHERMAN ACT 19 (1991).

42 Ibid.

Possible Efficiency Defence:⁴³

Once a plaintiff has established the two elements the predatory conduct is illegal - subject to a possible efficiency defence. Krattenmaker and Salop do not take a position on this, as it is unclear whether United States courts allow it. If a court permitted such a defence, it would ask "whether the conduct generated any significant offsetting efficiency benefits or cost savings that can only be achieved by permitting the exclusionary [predatory] practice".⁴⁴ If so, a court would not condemn the predator.

Krattenmaker and Salop's luke warm reaction to an efficiency defence is partly due to the difficulty in discovering measuring the efficiency of a cost raising device. No one has ever done so. Thus, they place the burden of proving the cost raising strategy had overwhelming efficiencies on the predator.

They suggest such a predator should:

- a) develop standards for estimating the size of its claimed efficiencies,
- b) show it could not obtain the efficiencies by less anticompetitive means,
- c) distinguish between pecuniary economies and real efficiencies and count only the latter,
- d) establish standards for distinguishing among effective exclusion resulting in price increases that:
 - i) only transfer wealth from consumers to stockholders,
 - ii) generate activities that siphon wealth from consumers to

43 Krattenmaker & Salop, *supra*, note 1, at 277-282.

44 Krattenmaker & Salop, Analysing Anticompetitive Exclusion, 56 ANTITRUST L. J., 71, 76 (1987).

- nonproductive entities,
- iii) provide incentives for wealth - increasing innovation.⁴⁵

Summary of the RRC Analysis

1. Is there an exclusionary right which enables the predator to exclude its rivals from an input?
2. Did the exclusion enable the predator to significantly raise its rivals' costs by one or more of the four postulated scenarios? i.e. did the predator harm its rival? (harm to a competitor).
3. If so, did the predator gain power over price in the output market? (harm to competition).
4. Did the conduct have any overriding efficiencies that justify it, despite it having raised rivals' costs?

45 Ibid.

CHAPTER IV

CRITIQUE OF RRC MODEL

INTRODUCTION:

The RRC model has received world wide academic acclaim.¹ Three United States Circuit Courts of Appeal have cited the model.² Of those three two have expressly applied it.³ Other courts have applied an RRC type analysis without expressly citing the model.⁴ Numerous commentators have examined the model and pointed out weakness. I now outline and discuss these criticisms.

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- 1 MacCrimmon and Sadanand, Models of Behaviour and Competition Law : Exclusive Dealing, 27 Osgoode Hall L.J. 709 (1989) (arguing Canadian Courts should use the RRC model to analyse Exclusive Dealing under s. 77 Competition Act); VAUTIER, FARMER and BAXT, CER AND BUSINESS COMPETITION-AUSTRALIA AND NEW ZEALAND IN A GLOBAL ECONOMY 103 (1990); G. FRASCO. EXCLUSIVE DEALING, A COMPREHENSIVE CASE STUDY 18-23 (1981); Pathat, Articles 85 and 86 Anticompetitive Exclusion in EEC Competition Law, ECLR 74 (1989) (arguing European courts should use the RRC model to analyse cases under Articles 85 and 86 of the Treaty of Rome); Easterbrook, Monopolisation : Past, Present and Future, 61 ANTITRUST L.J., 99, 107 (1993) (arguing one of the two methods of predation is raising rivals' costs).
 - 2 Premier Electrical Construction Co. v National Electrical Contractors Association Inc., 814 F. 2d 358, 368 (7th Cir. 1987); Ball Memorial Hospital, Inc. v Mutual Hospital Insurance, Inc., 784 F. 2d 1325, 1329 (7th Cir. 1986); U.S. v Western Electric Co., Inc., 767 F. Supp. 309 (1991).
 - 3 Premier Electrical and Western Electric, *supra*, note 2.
 - 4 See, e.g. Reazin v Blue Cross and Blue Shield of Kansas, 334 F. 2d 951 (10th Cir.), cert. denied, 110 S. Ct. 3241 (1990).

1 The model does add anything new

Commentators, such as Professor Timothy Brennan, argue that the model is redundant because existing antitrust law already prohibits conduct which the model identifies as anticompetitive.⁵ The model does not add anything new. Brennan notes: "[the model] offers virtually nothing as an antitrust theory that is not already subsumed in current theories".⁶

Judge Frank Easterbrook notes: "[T]he inquiry into rivals' costs simply repackages old questions".⁷ Ironically, Judge Easterbrook is one of only two judges who has cited and applied the concept.⁸ Indeed, he has favourably commented on the model in his academic writings.⁹ Accordingly Professor Wayne Calkins, after noting: "one is hard-pressed to identify many instances where one could find a violation for "raising rivals' costs" but not under conventional [antitrust] law", characterises the theory as "old wine in new bottles".¹⁰

With respect, this criticism is not valid. Krattenmaker and Salop have never claimed that the purpose of the model was to revolutionise or extend the

5 Brennan, Understanding Raising Rivals' Costs, 33 ANTITRUST BULL., 95 (1988).

6 Id. at 103.

7 Easterbrook, Allocating Antitrust Decisionmaking Tasks, 76 GEO. L. J., 305, 314-315 (1987).

8 See *supra*, note 2. He applied the concept on Premier Electrical.

9 Easterbrook, *supra*, note 1; Easterbrook, The Inevitability of Law and Economics, 1 LEGAL EDUCATION REV., 3, 17 (1989).

10 Calkins, Comments on Presentation of Steven C. Salop, 56 ANTITRUST L. J., 65, 65 (1987).

boundaries of existing antitrust law. Their purpose is "to provide a unified analysis"¹¹ of potentially predatory practices such as tying arrangements, exclusive dealing, refusals to deal and the like. Similarly their goal is to provide an understandable and applicable model to assess strategic behaviour. As mentioned, earlier predators can use such practices as exclusive dealing as strategic devices to decrease competition. No one disputes this. One of the problems with assessing strategic behaviour is that prices may not change. Traditional Chicago School analysis does not capture such instances. As Judge Richard Posner notes static classical economic assumptions have meant the Chicago School has not taken much notice of strategic behaviour: "Since classical ... economics contains no generally accepted theory of strategic behaviour, it is not surprising that the Chicago School should not have been particularly concerned with predatory pricing".¹² The same must be true of nonprice predation - the other form of strategic behaviour.

The RRC model enables courts to condemn strategic nonprice predation as it recognises that a predator may be keeping prices from falling.

That the model does not extend conventional antitrust law does not mean it fails. The test is whether it provides a unified analysis of the potentially predatory practices and whether it addresses nonprice strategic behaviour. In both cases the answer is yes. It offers a fresh and easily understood perspective.

11 Krattenmaker & Salop, Anticompetitive Exclusion : Raising Rivals' Costs to Achieve Power Over Price, 96 YALE L.J. 209, 214 (1986).

12 Posner, The Chicago School of Antitrust Analysis, 127 U. PA. L. REV., 924, 939 (1979).

It uses classical price theory¹³ and models to point out why and how nonprice strategic behaviour is anticompetitive. As Calkins notes "[I]t reflects some rigorous thinking about strategic behaviour thinking that may supply the theory behind a monopolization case ...".¹⁴ The model may be "old wine in new bottles", but as Calkins notes "If it is good wine and will attract customers after rebottling, so much the better".¹⁵

2 The model does not distinguish clearly between competitive and anticompetitive behaviour

This criticism applies to every theory of predation. As mentioned earlier, any predation theory must distinguish between predation and normal methods of competition which antitrust should encourage - not condemn. The model clearly identifies the harmful business practice - raising rivals' costs. The issue is whether it has established criteria by which courts can condemn harmful behaviour without condemning desirable business behaviour. In the words of Judge Easterbrook, does it cause too many "false positives".¹⁶ A false positive is a beneficial business practice which courts falsely condemn as anticompetitive.

As mentioned above, this can be particularly difficult in the context of nonprice predation and raising rivals' costs. Professors Thomas Sullivan and

13 The model is similar to Areeda & Turner's test for predatory pricing in that both use static classical price theory to explain strategic behaviour. Areeda & Turner, Predatory Pricing and Related Practices Under Section 2 of the Sherman Act, 88 HARV. L. REV., 697 (1975).

14 Calkins, *supra*, note 10, at 69.

15 *Id.* at 65.

16 Easterbrook, The Limits of Antitrust, 63 TEX. L. REV., 1 (1984).

John Harrison note:

" Many activities that cause the costs of competitors to increase are simply the side effects of "competition on the merits." Others may be specifically designed to harm competitors without benefiting consumers. The mere fact that an action raises the costs of rivals does not mean one can escape the issue that plagues monopolization law : when is the activity ultimately beneficial and when is its primary purpose the exclusion or hampering of others?"¹⁷

In short critics doubt the model provides adequate guidelines to distinguish between predation and competition on the merits.¹⁸ If courts use the model it will condemn much beneficial behaviour. It will spread liability too widely. Consequently it may discourage innovation, aggressive rivalry and other forms of procompetitive behaviour.

The critics perceive the problem with the model is that normal competitive behaviour raises rivals' costs. There are numerous examples. Salop and Scheffmann argue a predator can use advertising to raise rivals' costs.¹⁹ Existing rivals and potential market entrants will have to respond to the predator's advertisements. Such firms will be smaller than the predator, so the advertising will cost them proportionately more. A predator can increase its rivals' costs even more, if engages in comparative advertising which criticises its rivals' products. The rivals will probably have to do more advertising than the predator to offset the predator's advertising. Yet advertising is simply normal

17 T. SULLIVAN & J. HARRISON, UNDERSTANDING ANTITRUST AND ITS ECONOMIC IMPLICATIONS 239-240 (1988).

18 See, e.g. Marvel, Book Review, 8 REVIEW OF INDUSTRIAL ORGANISATION, 127 (1993).

19 Salop & Scheffman, Raising Rivals' Costs, 73 AM. ECON. REV., 267, 268 (1983).

competitive behaviour. A firm has to advertise to survive. The predator's comparative advertising may be true. No liability can attach.

Property rights can raise the costs of rivals who do not own the property. As Professor Wesley Liebeler notes "General Motors presumably increases Ford's costs by denying it the use of General Motors' plant".²⁰

Normal competitive bidding for inputs will raise rivals' costs. A firm who offers employment to a rival's key employee will raise the rival's costs if the rival has to offer a larger salary to keep the employee.²¹

An innovative firm which introduces a new product will raise its rivals' costs. Rivals will have to spend significant amounts to develop a similar product. They will have to undertake extensive advertising and distribution programmes to sell their now outdated products. The economy encourages and rewards such innovation. The innovator's purpose was to innovate and make more money. That it raised rivals' costs was ancillary to its purpose. The model's critics argue that the model will condemn such behaviour.²² I disagree. The model does not impose liability for simply raising rivals' costs. The predator must gain market power in the sense of being able to price supracompetitively. This may be by increasing prices or preventing them from falling. It is unlikely the advertising property rights or bidding for rivals' employees scenarios will do this. However, it may be true in the case of product innovation. A producer of a new superior

20 Liebeler, Exclusion and Efficiency, AEI REG. J., 34, 38 (1987).

21 ABA ANTITRUST SECTION : MONOGRAPH NO. 18 NONPRICE PREDATION UNDER SECTION 2 OF THE SHERMAN ACT 9 (1991).

22 Marvel, *supra*, note 17 at 9.

product will be able to charge above marginal cost for some time period. However, the innovator should still not be liable under the model. Krattenmaker and Salop devised the model for courts to use under Section 2 Sherman Act. It does not replace traditional Section 2 analysis. It is an adjunct to it. The innovator would not be liable as it is doubtful it had any purpose to create or maintain a monopoly. Certainly the innovator would not be liable under section 36 Commerce Act 1986. I will explain why in the next chapter.

The model's critics next objection is that it does not distinguish clearly between efficiency enhancing arrangements which raise rivals' costs and anticompetitive arrangements which also raise rivals' costs.²³ Normal rivalry demands that a firm keep its costs low. One way of doing this is to acquire exclusive commitments from the lowest cost suppliers. This may save significant amounts in transaction costs. By excluding rivals from these suppliers the firm has raised rivals' costs. This strategy is Krattenmaker and Salop's Bottleneck or Real Foreclosure scenario. The critics argue to condemn such behaviour would be to condemn an efficient firm.²⁴ Professor Oliver Williamson has argued such commitments are efficiency enhancing as they help the firm reduce its own costs.²⁵

Similarly the commitments may not only reduce transaction costs they may prevent free riding by rivals. This too enhances efficiency. Similarly,

23 Id; Tharp, Raising Rivals' Costs : Of Bottlenecks, Bottled Wine and Bottled Soda, 84 NW. U.L. REV. 321, 343 (1989).

24 Tharp, *ibid*.

25 O. WILLIAMSON, MARKETS AND HIERARCHIES : ANALYSIS AND ANTITRUST IMPLICATIONS (1975).

Professor Herbert Hovenkamp argues that the model does not undertake a proper balancing of pro and anti-competitive effects.²⁶ He notes the model seeks to identify conduct that significantly and unavoidably raises rivals' costs, but adopts structural tests to determine whether such a test is likely. The tests only identify the plausibility not likelihood of raising rivals' costs just as weather conducive to a tornado only suggests that a tornado is plausible not 50 per cent likely.²⁷ He argues antitrust should not condemn a firm on a plausibility.

He argues that the model by inferring anticompetitive behaviour from market structure but demanding empirical proof of efficiencies is flawed. He argues there is no basis for assuming that exclusive dealing and the like is motivated by predatory rather than efficiency concerns. To do so, as the model does, will result in courts condemning all such arrangements. While such arrangements will raise rivals' costs more when a large firm uses them - the cost savings flowing from them will be greater as well. Thus, he argues the model does not take sufficient account of efficiencies.²⁸ The critics argue that the model understates the efficiency enhancing benefits of actions that raise rivals' costs.²⁹

However the model postulates an efficiency defence. The firm who claims efficiency benefits must prove them. The criticism is relevant to a

26 Hovenkamp, Antitrust Policy, Restricted Distribution and the Market for Exclusionary Rights, 71 MINN. L. REV. 1293, 1304 (1987).

27 *Id.* at 1304.

28 *Id.* at 1311-1312.

29 Marvel, *supra*, note 17, at 14; Tharp, *supra*, note 22.

Sherman Act Section 1 claim where courts undertake a rule of reason analysis, i.e. courts assess and weigh the pro and anticompetitive effects of an arrangement. The same is true of Section 27 of the Commerce Act. Whether courts can undertake such an analysis under Section 36 is still uncertain.³⁰ Thus, the model may be correct in not expressly and definitively incorporating an efficiency defence.

The model is a model for assessing predation claims. Thus, under Section 36 a predator must have a dominant position in the appropriate market. This will decrease the danger of false positives. I further analyse this in Chapter V where I discuss the constituent elements of Section 36 and its applicability to the model.

3 Simply raising rivals' costs is enough for liability

The model requires two steps : first raising rivals' costs and second the increased costs must give the predator the power to raise or stabilise market price.³¹ The criticism is that to raise rivals' costs a predator requires control over the input market, i.e. the predator must have market power over the input market. This market power is enough for liability.

However, in the case of single firm behaviour, simply having market power is no breach of the antitrust laws. Simply monopoly pricing attracts no liability. It is different if two or more firms collude to gain market power.

30 See Chapter V.

31 Krattenmaker & Salop, Analysing Anticompetitive Exclusion, 56 ANTITRUST L.J. 71, 76-77 (1987).

Krattenmaker and Salop argue the second step is necessary because firms usually have no incentive to raise rivals' costs unless they also achieve power over price. As mentioned above, an action which raises rivals' costs may have significant efficiency justifications. Allowing firms simply to complain only about the first step, would be to allow firms to complain about (and thus, deter) efficient behaviour. This would place too heavy a burden of self-restraint on firms.³²

4 Raising rivals' costs strategies are so rare as to be insignificant

Hovenkamp argues the model is at its best when the exclusionary right involves naked exclusionary behaviour.³³ Krattenmaker and Salop give the example of Alcoa paying electricity suppliers not to supply Alcoa's competitors.³⁴ Apart, from abuse of judicial and administrative processes, this is the only example of a naked exclusionary right they can identify.³⁵ Professor John Lopatka and Doctor Paul Godek have pointed out Alcoa entered into no such contracts.³⁶ Analysing the court testimony, they say Alcoa never contracted with utilities for the utilities to withhold power from rivals that were unattached to power or incipient power purchasers. They argue the contracts

32 Id.

33 Hovenkamp, *supra*, note 25, at 1304.

34 Krattenmaker & Salop, *supra* note 10, at 215-217.

35 *Ibid.*

36 Lopatka & Godek, Another Look At Alcoa : Raising Rivals' Costs Does Not Improve the View, 35 J.L. & ECON., 311 (1992).

were simple exclusive dealing contracts. The only occasions where Alcoa did not use power, were for short periods when it was constructing facilities next to the utilities. In any event, Alcoa commanded so little of the electric power market that it could not raise rivals' costs.³⁷ This however does not weaken the model. Krattenmaker and Salop only give Alcoa's contracts as a potential example of a naked exclusionary right. They apply the RRC analysis to Alcoa. They do not say Alcoa breached the model, as they do not have the requisite information. They use Alcoa as an example to demonstrate the RRC methodology.

Another tactic for raising rivals' costs is a predator overbuying some input. The overbuying involves the predator buying more of the input it needs. This can be either the Bottleneck or Real Foreclosure scenarios. Krattenmaker and Salop again give the example of Alcoa. Alcoa possibly bought more bauxite than it needed. Krattenmaker and Salop say this could have raised rivals' costs.³⁸ Professor John Tharp,³⁹ along with Lopatka and Godek,⁴⁰ analyse the testimony and argue Alcoa was only reducing transaction costs by long term contracting. They thus conclude the model is of no use.

However, here again Krattenmaker and Salop do not offer Alcoa's overbuying as definitive RRC behaviour. They only use it to demonstrate the model's methodology. While Tharp et al. appear to be correct about the Alcoa case, this does not invalidate the model. Tharp et al. have knocked down a

37 Id. at 315-319.

38 Krattenmaker & Salop, *supra*, note 10, at 236.

39 Tharp, *supra*, note 22, at 354.

40 Lopatka & Godek, *supra*, note 35, at 320-324.

straw man. Krattenmaker and Salop offer no conclusions on Alcoa; they use it as a possible example.

In any event the model takes account of the concerns about overbuying as to raise rivals' costs. Krattenmaker and Salop require:

"proof that as a result of the inefficient resource use from overbuying, the purchasing firm's [predator's] marginal cost is, in effect, driven up to a level above the price it receives for its output. This burden would generally be very difficult for the plaintiff to carry; it is the equivalent of the Areeda-Turner test for predatory pricing as applied to input purchases".⁴¹

In any case, under Section 36 a dominant firm which has valid reasons for overbuying should not attract liability.

Although, the RRC model may be most easily understood when applied to naked exclusionary contracts, the fact naked exclusionary contracts are so rare does not invalidate the model.⁴²

5 Rivals have counterstrategies which can defeat the plan to raise their costs.

Some critics argue that rivals have counterstrategies that enable them to defeat the predator's cost raising strategies.⁴³ As rivals can readily do so the model does not merit antitrust concern.

Rivals can do so in a number of ways. First, rivals can obtain needed inputs from suppliers other than suppliers that enter into the exclusionary rights

41 Krattenmaker & Salop, *supra*, note 10, at 282 n. 228.

42 Rasmusen, Ramseyer & Wiley, Naked Exclusion, 81 AM. ECON. REV., 1137 (1991).

43 Easterbrook, Predatory Strategies and Counterstrategies, 48 U. CHI. L. REV., 263 (1981).

contracts. Unless the predator succeeds in tying up a dominant portion of the input market, a rival could contract with the remaining suppliers to satisfy its needs.⁴⁴ Where rivals can do this, the first stage of the RRC model is not satisfied. In some cases, especially with the Bottleneck scenario, this is not possible.

A second scenario is for rivals to integrate with suppliers. Thus, rivals can develop their own sources of inputs.⁴⁵ The mere threat of integration may prevent a predator from trying to obtain exclusionary rights contracts.⁴⁶ However, such a threat has to be plausible. It may not be so where the predator controls most of the market and the rivals are small firms.

A third counterstrategy is for rivals to bid against the predator for the exclusionary rights contract.⁴⁷ The bidding may go so high that both the predator's and rivals' costs are raised. However, the predator after having raised rivals' costs and begun making supracompetitive profits will be able to afford the suppliers' increased price.⁴⁸ In any event, in this scenario consumer welfare is harmed. The result of the strategy and counterstrategy is that everyone's costs are raised. The effect will be higher prices for consumers.

In relation to predatory product innovation, a firm that manufactures

44 ABA Monograph, *supra*, note 20, at 43.

45 Klein, Crawford & Alchian, Vertical Integration, Appropriable Rents, and the Contracting Process, 21 J.L. & ECON., 297 (1978).

46 ABA Monograph, *supra*, note 20, at 43.

47 Hovenkamp, *supra*, note 25, at 1313-1315.

48 Krattenmaker & Salop, *supra* note 10, at 265.

products that complement the predator's product, may develop a flexible manufacturing technique. This will enable it to quickly change its product to account for changes the predator makes in its product. This enables the firm to accommodate predator's altering their products to make them incompatible with rivals' products.⁴⁹

While rivals do have counterstrategies they are not so overwhelming as to invalidate the model.

6 Input suppliers won't enter exclusionary rights contracts

An exclusionary rights contract means a supplier loses a major buyer. To compensate for this, the supplier will charge a substantial premium. This will effectively substantially raise the predator's costs. However, the predator will be able to pay for this out of its supracompetitive pricing.⁵⁰ If the predator, is a well established dominant firm, suppliers may have no real choice in entering into exclusionary rights contracts.

Suppliers may not only supply in the same market as the predator and its rivals. For example, if Alcoa did pay utilities not to sell to rival aluminium companies, they could still sell to steel manufacturers, car manufacturers and other electricity consumers.

Another criticism is that suppliers will not grant exclusionary rights

49 Scherer, Antitrust Efficiency and Progress, 62 N.Y.U. L. REV., 998, 1014-1015 (1987) (discussing the resilience of peripheral equipment manufacturers in the face of IBM's efforts to exclude them from the market).

50 See, *supra*, note 47.

contracts as they are likely to lead them facing a monopsonist purchaser.⁵¹ This is not necessarily so. It depends on the exclusionary rights contract. Suppliers may be able to get out of the contract reasonably easily and quickly.

Thus, this criticism does not invalidate the model.

7 The Model is based on discredited leverage theory

This criticism is based on the Chicago School view of vertical integration. Such scholars argue that only one monopoly profit is possible in a chain of production. The firm that has a monopoly can make one monopoly profit in one market. It cannot extend or leverage its monopoly power into another market. It has already made its profit.⁵²

The criticism, as applied to the model, is that it assumes input suppliers can gain power simply by integrating with their purchaser. This view, however, assumes a monopoly input supplier. This is not necessarily so. Using the Alcoa example, Alcoa purchased exclusionary rights from a number of electricity utilities - not a national electricity supplier. In exclusive dealing the predator will contract with numerous retailers - not with a monopolistic retailer.

In some cases there will be a monopolistic supplier. However, the leverage criticism depends on the Chicago School view being correct.

The Chicago view is not unanimous. Professor Louis Kaplow argues a

51 ABA Monograph, *supra*, note 20, at 45.

52 R. BORK, *THE ANTITRUST PARADOX : A POLICY AT WAR WITH ITSELF*. 141-144 (2d ed. 1993); R. POSNER & F. EASTERBROOK, *ANTITRUST CASES AND MATERIALS*, 870 (1981).

monopolist can extend its profits by vertical integration and reducing competition in the output market. This occurs when:

- 1 entry barriers are heightened
- 2 integration facilitates price discrimination
- 3 integration avoids price regulation.⁵³

Krattenmaker and Salop make the same point.⁵⁴

In any event Section 36 of the Commerce Act expressly covers monopoly leveraging.⁵⁵

8 The Model is too complex

Professor Calkins argues the model is too complex for courts to administer. He argues the complexity will lead to courts and enforcement agencies misunderstanding it and either condemning normal behaviour or finding no liability whatsoever.⁵⁶

Brennan argues the only benefit of the model is that it enables lawyers to raise clients' costs.⁵⁷

While the analysis involved may require a court to consider many things - all antitrust litigation requires this. The time involved in doing so may be more

53 Kaplow, Extension of Monopoly Power Through Leverage, 85 COLUMB. L. REV., 515 (1985).

54 Krattenmaker & Salop, *supra*, note 10, at 248-249.

55 See Chapter V, *infra*.

56 Calkins, *supra*, note 10, at 68.

57 Brennan, *supra*, note 5.

in New Zealand, as New Zealand has no equivalent of the American summary judgment procedure. The only way to assess whether the criticism is correct is to apply it to section 36. This is what I shall do after outlining the constituent elements of section 36 in the next chapter.

CHAPTER V

SECTION 36 AND ITS CONSTITUENT ELEMENTS

Introduction:

Section 36(1) is the Commerce Act's predation section. Its goal is to prohibit predatory behaviour. A necessary corollary is that it must distinguish between normal competition and predation. New Zealand courts recognise this. Tipping J. neatly summed up s. 36's function in N.Z. Magic Millions Ltd v Wrightson Bloodstock Ltd¹ when he observed:

"[I] would venture the following proposition. It is not a breach of s. 36 if a person albeit with a dominant position, simply acts in a competitive manner. It would be an irony if such conduct could be attacked because it is competition which the Act is designed to promote".²

The section is entitled "Use of a Dominant Position in a Market". It reads:

- (1) No person who has a dominant position in a market shall use that position for the purpose of -
 - (a) Restricting the entry of any person into that or any other market;
or
 - (b) Preventing or deterring any person from engaging in competitive conduct in that or in any other market; or

1 [1990] 1 NZLR 731.

2 Id. at 761.

- (c) Eliminating any person from that or any other market.
- (2) For the purposes of this section, a person does not use a dominant position in a market for any of the purposes specified in paragraphs (a) to (c) of subsection (1) of this section by reason only that that person enforces or seeks to enforce any right under or existing by virtue of any copyright, patent, protected plant variety, registered design or trade mark.
- (3) Nothing in this section applies to any practice or conduct to which this Part of this Act applies which has been authorised pursuant to Part V of this Act.

The section has three constituent elements. It prohibits:

- (a) person who is in a dominant position in a market
- (b) from using that position
- (c) for the purpose of restricting entry in a market, deterring competitive conduct in a market or eliminating a person from a market.³

I shall analyse each element. Part II of this chapter will discuss "dominant position". However, I will only do so briefly. It is only the threshold condition for the operation of the section. It plays no part in distinguishing predation from normal competitive behaviour. Part III will discuss the "use" element. Part IV, the purpose element. In parts III and IV I will extensively refer to Australian law on s. 46 of the Trade Practices Act (1974). Part V discusses how the RRC model fits in with s. 36.

3 Hampton, Section 36(1) of the Commerce Act 1986 : An Analysis of its Constituent Elements, 179, 181-182 in COMPETITION LAW AND POLICY IN NEW ZEALAND (Ahdar ed. 1991).

Dominant Position in a Market:

Section 3(8) defines "dominant position" as follows:

For the purposes of sections 36, 66 and 67 of this Act, a dominant position in a market is one in which a person as supplier or an acquirer of goods or services, either alone or together with any interconnected body corporate, is in a position to exercise a dominant influence over the production, acquisition, supply, or price of goods or services in that market, and for the purposes of determining whether a person is in a position to exercise a dominant influence over the production, acquisition, supply, or price of goods or services in a market regard shall be had to -

- (a) The share of the market, the technical knowledge, the access to materials or capital of that person or that person together with any interconnected body corporate;
- (b) The extent to which that person is constrained by the conduct of competitors or potential competitors in that market;
- (c) The extent to which that person is constrained by the conduct of suppliers or acquirers of goods or services in that market.

The key phrases are "person", "in a position", "dominant influence" and "market". I shall only consider dominant influence.⁴ This threshold derives from Article 86 of the Treaty of Rome. This provides:

"Any abuse by one or more undertakings of a dominant position within the common market or in a substantial part of it shall be prohibited as incompatible with the common market in so far as it may affect trade between Member States. Such abuse may, in particular, consist in:

- (a) directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions;
- (b) limiting production, markets or technical development to the prejudice of consumers;

4 For a comprehensive account of these factors see Hampton, *supra*, note 3, at 182-186. See also, Brunt, Market Definition Issues in Australian and New Zealand Trade Practices Litigation, 115 in COMPETITION LAW AND POLICY IN NEW ZEALAND (Ahdar ed. 1991).

- (c) applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;
- (d) making the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage have no connection with the subject of such contracts".

The s. 3(8) definition equates with the economic definition of market power. This is the ability to raise price without losing sales to existing competitors or new entrants so the increase is unprofitable.⁵ However, as Hampton notes, the s. 3(8) definition with its phrase "exercise a dominant influence over production, acquisition, supply or price" expands the traditional economic definition.⁶ It is more than the ability to give less and charge more. Article 86 stresses that a dominant position involves the ability to act independently of one's rivals, customers and consumers. The E.C. Commission, in In re Continental Can Co.⁷ defined the concept of a dominant position as:

"Undertakings are in a dominant position when it is possible for them to behave independently which puts them in a position to act without regard to their competitors, purchasers or suppliers. That is the case when, because of their share of the market, or because of their share of the market combined with the availability of technical knowledge, raw materials or capital they have the power to determine prices or to control production or distribution for a significant part of the products in question. This power does not

5 F. SCHERER, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE 10-11 (2d 1980); H. HOVENKAMP, ECONOMICS AND FEDERAL ANTITRUST LAW 55 (1985); P. AREEDA & D. TURNER, ANTITRUST LAW, Vol. II 321-346 (1978); Posner and Landes, Market Power in Antitrust Cases, 94 HARV. L. REV., 937 (1981).

6 Hampton, *supra*, note 3, at 186.

7 [1992] CMLR D.11.

necessarily have to result from an absolute dominance enabling the undertakings which hold it to eliminate all power of decision on the part of their economic partners but it is sufficient that they be strong enough as a whole to ensure those undertakings complete freedom of action even though their influence on the individual market segment varies in degrees".⁸

As yet, no New Zealand court has considered the meaning of a "dominant position" in the context of a s. 36 case. The case law points out that s. 3(8) derives from the European case law on Article 86.⁹ Cases involving mergers cited the European approach with approval; notably Davison C.J. in Lion Corporation Ltd v Commerce Commission.¹⁰ Tipping J. cited Lion in Magic Millions.¹¹ The Court of Appeal also did so in Electricity Corp. Ltd v Geotherm Energy Ltd.¹²

"The concept of dominant position in the New Zealand Act appears to have been drawn from the European law. This is referred to in the judgment of Davison C.J. in Lion Corporation Ltd v Commerce Commission [1987] 2 NZLR 682, 690 in which he refers to the meaning of "dominant position" adopted by the Commerce Commission as:

'Dominance is a measure of market power. Being in a "dominant position" is interpreted by the Commission, in essence, as having sufficient market power [economic strength] to enable the dominant party to behave to an appreciable extent in a discretionary manner without suffering detrimental effects in the relevant markets[s]'.

8 Id. at D. 27.

9 See, for example, Auckland Regional Authority v Mutual Rental Cars (Auckland Airport) Ltd [1987] 2 NZLR 647, 679; Tru Tone Ltd v Festival Records Retail Marketing Ltd [1988] 2 NZLR 352.

10 [1988] 2 NZLR 682.

11 Supra, note 1.

12 [1992] 2 NZLR 641.

This is a conversion of the statutory language into the language of economists..."¹³

Thus, it appears "dominant position in a market" equates with the Australian s. 46 "threshold of a substantial degree of power in a market."¹⁴ However, this is uncertain as the Court of Appeal in a merger case, Telecom Corporation of N.Z. Ltd v Commerce Commission¹⁵ held it was not prepared to read "dominant" as meaning "substantial market power". Cooke P. held only one person can be dominant and drew on the dictionary to define dominant position.¹⁶ The Court eschewed the economic concept of dominance.

Commentators have severely criticised the decision.¹⁷ However, the

13 Id. at 648-649.

14 Section 46 of the Trade Practices Act provides:

"(1) A corporation that has a substantial degree of power in a market shall not take advantage of that power for the purpose of:

- (a) eliminating or substantially damaging a competitor of the corporation or of a body corporate that is related to the corporation in that or any other market;
- (b) preventing the entry of a person into that or any other market; or
- (c) deterring or preventing a person from engaging in competitive conduct in that or any other market."

15 [1992] 3 NZLR 429.

16 Id. at 442.

17 Patterson, The Rise and Fall of a Dominant Position in New Zealand Competition Law : From Economic Concept to Latin Derivation, 15 NZULR 265 (1993).

decision arguably is irrelevant to s. 36. As Hampton notes, "dominant position" plays different roles in s. 36 and the merger provisions. In the merger provisions it is the standard by which the Commerce Commission or the courts determine whether a business acquisition breaches the Act. In s. 36 it is simply a threshold for the operation of the section.¹⁸ Thus, "dominant position" plays no role in distinguishing normal competition from predation. That is the role of the "use" and "purpose" provisions.

Use:

Courts have recognised that it will often be difficult to separate the use and purpose elements of s. 36. They are often interconnected. As Gault J. observed in Electricity Corp. Ltd v Geotherm Energy Ltd:¹⁹

"The conduct prohibited by the section [section 36] is the use of the dominant position for the proscribed purposes. There will be circumstances in which the use of the market position and the purposes are not easily separated but the two requirements must be kept in mind".²⁰

Despite the difficulty the courts consider "use" as a separate inquiry which a plaintiff has to establish to prove a breach of s. 36. Indeed in Williams v Papersave Pty Ltd²¹ both the Federal and Full Federal Court of Australia found that the defendant had a substantial degree of market power and the

18 Hampton, Aspects of the Commerce Act, 635, 750 in BUTTERWORTHS COMMERCIAL LAW (J. Farrar & A. Borrowdale eds. 2d. ed 1992).

19 Supra, note 12.

20 Id. at 646.

21 (1987) ATPR, para 40-781, affirmed on appeal (1987) ATPR, para 40-818.

requisite purpose. However, the defendant had not breached s. 46, as it had not "taken advantage" of its market power. Thus, use is a separate and requisite limb which a plaintiff must prove to establish s. 36 liability. The "use" limb helps courts distinguish between predation and normal competition.

The most important case on "use" is the High Court of Australia's decision Queensland Wire Industries Pty Ltd v Broken Hill Pty Ltd.²² The High Court equated "take advantage of" with "use". Thus, the case is extremely relevant to s. 36. Broken Hill Pty Ltd (BHP) produced 97 per cent of steel in Australia. It supplied 85 per cent of the country's steel and steel products. It also manufactured "Y-bar" feed stock. Y-bar is used in the manufacture of star picket fences. BHP was Australia's only manufacturer of Y-bar. Y-bar was the only product BHP did not sell generally. BHP sold Y-bar only to Australian Wire Industries - one of its wholly-owned subsidiaries. Queensland Wire Industries Pty Ltd (QWI) manufactured galvanised wire from rods it obtained from BHP. It also acquired star picket posts from BHP and competed with BHP in the rural fencing market in Queensland. QWI had a 28 per cent share of that market. QWI requested BHP supply it with Y-bar. It wanted to manufacture star picket posts. BHP declined, saying its policy was to refuse supply, or to offer supply at an uncompetitive price, because it wanted to keep the manufacturing of star picket fences to itself. QWI sued alleging breach of s. 46. At first instance,²³ Pincus J. found BHP had a substantial degree of market power and the requisite purpose. It had not taken advantage of its market

22 (1989) ATPR, para 40-925.

23 (1987) ATPR, para 40-818.

power. Thus QWI's claim failed. He held "take advantage" required some reprehensibility of conduct. After examining authority he held:

"What all the cases referred to above have in common, in my opinion, is that they are consistent with a reading of "take advantage of" which is pejorative and not neutral. While I cannot (with respect) accept that characterising the acts complained of as merely an exercise of legal rights, whether contractual or otherwise, can be an answer to a claim based on s. 46, it appears to me that the Australian cases tend to support the view that there is not taking advantage unless there is a misuse of power".²⁴

Pincus J. held a plaintiff had to show that the conduct was "unfair", "restrictive", "predatory" or "would ordinarily be regarded as reprehensible" before a court would call it "taking advantage of" market power. BHP had done nothing commercially reprehensible in refusing to supply QWI.

The Full Federal Court held that as BHP had never sold Y-bar, no market for Y-bar existed so s. 46 did not apply.²⁵ The Court consequently did not discuss "take advantage".

The High Court unanimously rejected Pincus J.'s views.²⁶ It held courts were to interpret "take advantage" in a neutral, not pejorative sense. Mason C.J. and Wilson J. held:

"Pincus J. suggested that the phrase "take advantage" requires that the defendant be doing something 'reprehensible'. His Honour also used the phrases '[competition] deserving of criticism' and 'predatory or unfair', apparently as equivalents for 'reprehensible'. It is unclear precisely what the phrases are supposed to mean, but they suggest some notion of hostile intent. For our part, we have difficulty in seeing why an additional, unexpressed and ill-defined standard should be implanted in the section. The phrase 'take

24 Id. at 48, 819.

25 (1988) ATPR, para 40-925.

26 Supra, note 12.

advantage' in s. 46(1) does not require a hostile intent inquiry - nowhere is such standard specified. And it is significant that s. 46(1) already contains an anticompetitive purpose element. It stipulates that an infringement may be found only where the market power is taken advantage of for a purpose proscribed in para (a), (b) or (c). It is these purpose provisions which define what uses of market power constitute misuses".²⁷

Similarly, Deane J. held:

"It is true that the words 'take advantage of' can be used with an adverse moral implication. This is particularly the case where the words are used with another person as their object. Of themselves, however, the words 'take advantage of ... power' are morally indifferent. As a matter of language, a parliament can 'take advantage' of its legislative power to make good laws; a government can 'take advantage' of its executive power to protect and benefit the community; a trading corporation can 'take advantage' of its trading power to advance trade and competition to the benefit of its shareholders, its employees and those with whom it deals; an ordinary person can 'take advantage' of such power as he possesses to achieve objectives which are praiseworthy and socially desirable. Read in context, the words 'take advantage of ... power' are simply inadequate to superimpose upon the economic notions and objectives which s. 46(1) reflects some indefinite moral or public purpose qualification requiring circumstances where the active or passive use of the relevant market power for one or other of the 'designated anti-competitive purposes is morally or socially undesirable'.²⁸

Dawson J., who generally agreed with Deane J., also held: "that the words 'take advantage of' do not have moral overtones in the context of s. 46".²⁹

Toohey J. also rejected Pincus J.'s pejorative interpretation of take advantage. He relied on the dictionary meaning of "take advantage of" and the Blunt Committee to hold that "take advantage of" means "use". His Honour held:

27 . Id. at 50, 010.

28 Id. at 50, 012.

29 Id. at 50, 016.

"Counsel for QWI accepted that s. 46, read as a whole, imports the notion of misuse of power.' But, he said, that notion is not to be derived just from the words 'take advantage of'. The element of misuse is supplied by the requirement in s. 46(1), after the amendments of 1977, that the taking advantage of power must be for a proscribed purpose. Counsel invited the Court to treat the words 'shall not take advantage of that power for the purpose of' as a composite expression involving two elements. On this approach, it is unnecessary and unhelpful to employ expressions such as 'predatory'. There is no breach of s. 46 unless there has been a use of market power for one of the purposes proscribed by the section. But once it appears that there has been a use of market power for such a purpose, the section has been contravened and it adds nothing to consider the motives of the corporation taking advantage of the market power which it has.

The interpretation relied on by QWI is, in my view, the correct one. It gives effect to the ordinary meaning of the expression 'take advantage of' which the Shorter Oxford English Dictionary (1973), vol. 1, speaks of as '[t]o take, make one's a[dvantage] of a thing: to use any favourable condition it offers' and by the Macquarie Dictionary (1981), as 'to make use of: to take advantage of an opportunity'. That too was the opinion of the Blunt Committee which considered that the words 'take advantage of' mean 'use market power', that is they are a reference to the 'overt deliberate exercise of market power' (Trade Practices Consultative Committee) (Blunt Committee): Small Business and the Trade Practices Act (1979), vol. 1, p. 70, para. 9.27). The Blunt Committee recommended, in that same paragraph, that the words 'take advantage of' be replaced by 'use' to avoid any confusion and misunderstanding. That recommendation was not adopted. If there is a distinction between those expressions, it perhaps lies in the notion that 'use' carries a sense of positive action while 'take advantage of' may stem from mere passivity. But I doubt that in truth there is any real distinction involved."³⁰

The High Court held that to take advantage of market power is to do something which a firm can only do because of its market power - i.e. to do something which it could not do in a competitive market. Mason C.J. and Wilson J. held:

"In effectively refusing to supply Y-bar to the appellant, BHP is

taking advantage of its substantial market power. It is only by virtue of its control of the market and the absence of other suppliers that BHP can afford, in a commercial sense, to withhold Y-bar from the appellant. If BHP lacked that market power - in other words, if it were operating in a competitive market - it is highly unlikely that it would stand by, without any effort to compete, and allow the appellant to secure its supply of Y-bar from a competitor".³¹

Similarly, Deane J. held:

"As has been said, BHP is prepared to sell to outsiders any of the products from its rolling mills with the exception of Y-bar. It has, on some occasions in the past, sold Y-bar to overseas purchasers. Its refusal to supply Y-bar to QWI otherwise than at an unrealistic price was for the purpose of preventing QWI from becoming a manufacturer or wholesaler of star pickets. That purpose could only be, and has only been, achieved by such a refusal of supply by virtue of BHP's substantial power in all sections of the Australian steel market as the dominant supplier of steel and steel products. In refusing supply in order to achieve that purpose, BHP has clearly taken advantage of that substantial power in that market".³²

Dawson J. took a similar view stating:

"[T]here can be no real doubt that BHP took advantage of its market power in this case. It used that power in a manner made possible only by the absence of competitive conditions. Inferences in this regard can be drawn from the fact that BHP could not have refused to supply Y-bar to QWI if it had been subject to competition in the supply of that product. BHP supplies all its other steel products without restriction and its practice with regard to Y-bar was not in accordance with its normal behaviour. If there had been a competitor supplying Y-bar, BHP's refusal to supply it to QWI would have eroded its position in the steel products market without protecting AWT's position in the fencing materials market. Moreover, the existence of barriers to entry into the steel products market must inevitably, upon the findings of the trial Judge, have influenced BHP in the course which it took".³³

31 Id. at 50, 011.

32 Id. at 50, 014.

33 Id. at 50, 016 - 50, 017.

Toohy J. concluded similarly saying:

"The only reason why BHP is able to withhold Y-bar (while at the same time supplying all the other products from its rolling mills) is that it has no other competitor in the steel product market who can supply Y-bar. It has dominant power in the steel products market due to the absence of constraint. It is exercising the power which it has when it refuses to supply QWI with Y-bar at competitive prices; it is doing so to prevent the entry of QWI into the star picket market; and it has been successful in that attempt".³⁴

The High Court's approach to determine whether a firm has taken advantage of its market power is to ask whether that firm would have acted differently if it were in a competitive market. As the Trade Practices Commission puts it: "whether its conduct was made possible only by the absence of competitive conditions".³⁵ The Commission also framed the test as:

"[W]hether the conduct of the powerful corporation was only commercially feasible because of the certain degree of freedom the corporation enjoyed from competitive constraints. A powerful corporation will be found to have taken advantage of market power if it could not have so acted without market power".³⁶

Professor Warren Pengilley has criticised this aspect of the decision.³⁷ He argues that the High Court was incorrect in assuming that had BHP been in a competitive market it would have supplied QWI. He comments: "[W]e all know that any number of companies subjected to competitive conditions

34 Id. at 50, 025.

35 Trade Practices Commission, Misuse of Market Power - A background paper, 27 (Feb. 1990).

36 Id. at 36.

37 Pengilley, Denial of Supply and Misuse of Market Power in Australia : What Follows from the High Court Decision in Queensland Wire?, Special Report, ATPR (1989).

frequently choose not to supply their products to outside entities".³⁸

However, it was not BHP's mere refusal to supply that breached s.46. It was the refusal in the context of the market and case. Had the market been competitive it would not have been commercially sensible for BHP to refuse to supply. The High Court acknowledged that a firm with substantial market power can refuse to supply if it had a legitimate reason.³⁹ BHP had none. Thus, its refusal was not commercially sensible. As Hampton notes about QWI and the take advantage limb:

"... the basic thrust of the Justices' reasoning is sound in that it seeks to confine the role of the misuse provision to conduct which has its source either wholly or partially in market power".⁴⁰

QWI implies that the substantial market power must be the cause of the impugned conduct. It is in essence, a "but for" test. The conduct was not possible, but for the substantial market power.

Subsequent Australian Courts have followed QWI's reasoning on "take advantage". One such case is Dowling v Dalgety Australia Ltd.⁴¹ Here three pastoral houses, Dalgety, Elders and Primac, formed an association called Goondiwindi Livestock Auction Sales Association. Through the Association they jointly owned the saleyards at Goondiwindi. The respondents each provided auction services at the sales yard. Dowling, a local auctioneer and agent applied to join the association. The association refused. It did not want anyone else to

38 Id. at 16.

39 Supra, note 12, at 50, 011 per Mason C.J. and Wilson J.

40 Hampton, supra, note 3 at 199.

41 (1992) ATPR, para 41-165.

run livestock auctions at the sales yards as it owned them. Dowling sued alleging breach of s. 46.

Lockhart J. held the association did not have a substantial degree of power in the relevant power. His Honour however, considered the "take advantage" limb of s. 46. He said:

"The central determinative question to ask is: has the corporation exercised a right that it would be highly unlikely to exercise or could not afford for commercial reasons to exercise if the corporation was operating in a competitive market?"⁴²

His Honour, reinforcing the test, commented:

"Competition by its very nature is deliberate and ruthless and s. 46 encourages this. What it discourages is conduct which would not be possible in a competitive market, thereby promoting competitive conduct".⁴³

His Honour held, in refusing Dowling membership, the association had not acted in a way made possible by lack of a competitive market. His Honour further said the association was not in the business of granting licences or leases of saleyards. It was in the business of providing livestock selling services.⁴⁴ This presumably means the association might have met the take advantage limb of s. 46 if it was in the business of leasing or licensing saleyards. As it had never granted leases or licences no one could argue it would do so in a competitive market. His Honour also considered it was self-evident that a firm is equally unlikely to licence its private property to a rival, whether the market is

42 Id. at 40, 277.

43 Ibid.

44 Id. at 40, 278.

competitive or uncompetitive.⁴⁵

The Federal Court in Natwest Australia Bank Ltd v Boral Gerrard Strapping Systems Pty Ltd⁴⁶ followed QWI. The respondent was the exclusive supplier of strapping products vital to the applicant's wool processing business. The applicant owed the respondent money. The respondent refused to supply the applicant⁴⁷ until it repaid the debt.

French J. held the respondent had not taken advantage of its market power. His Honour held:

"If a corporation with substantial market power were to engage an arsonist to burn down its competitor's factory and thus deter or prevent its competitor from engaging in competing activity, it would not thereby contravene s. 46. There must be a causal connection between the conduct alleged and the market power pleaded such that it can be said that the conduct is a use of that power. In many cases the connection may be demonstrated by a showing of reliance by the contravener upon its market power to insulate it from the sanctions that competition would ordinarily visit upon its conduct".⁴⁸

His Honour held the facts showed no link between the refusal to supply and the respondent's market power. Any firm in the respondent's position would refuse to supply in the circumstances, irrespective of the presence of competition.

Similarly, the Federal Court in General Newspapers Pty Ltd v Australian

45 Ibid.

46 (1992) ATPR, para 41-196.

47 Natwest Australia Bank was actually an appointed agent and mortgagee in possession of the assets of Irving Pastoral, a wool processing, baling and selling company. Natwest was the receiver under the debenture.

48 Id. at 40, 644.

and Overseas Telecommunications Corp. Ltd⁴⁹ held:

'The Court must ... consider whether, even without substantial market power, the person might have been able to make the same decision. A decision to contract with a particular person will normally not be an exercise of market power'.⁵⁰

Spender J. in David's Holdings Pty Ltd v Coles Myer Ltd⁵¹ held that a retailer acquiring shares in another retailer is not taking advantage of market power, even if market power and the requisite purpose exist. The reason was that such conduct is possible in a competitive market.

Professor Warren Pengilley argues that the Trade Practices Commission's written submission in support of its application for leave to intervene influenced the High Court's test for "take advantage" in QWI.⁵² The Commission submitted:

"BHP ... can only refuse to supply QWI with impunity if it is confident that QWI cannot obtain supplies of Y-bar from any other source".⁵³

It further argued that because BHP had excess capacity in its steel mills it would have supplied QWI in a competitive market rather than lose sales to a rival. Only if it supplied QWI could it maximise profits.⁵⁴

As Doctor Stephen Corones notes,⁵⁵ the QWI test is similar to the U.S.

49 (1993) ATPR, para 41-215.

50 Id. at 40, 956.

51 (1993) ATPR, para 41-214.

52 Pengilley, *supra*, note 37, at 21.

53 Trade Practices Commission Submission, para 11.

54 Ibid.

55 Corones, *Misuse of Market Power*, 1 ATPR, para 5-295, 3, 761.

Second Circuit Court of Appeals test in Berkey Photo Inc. v Eastman Kodak Co.⁵⁶ Before discussing the New Zealand decisions on use, I shall briefly outline the U.S. law on monopolisation and use.

Section 2 of the Sherman Act governs monopolisation or dominant firm predation. It provides:

"Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons to monopolize any part of the trade or commerce among the several States, or with foreign nations, shall be deemed guilty of a misdemeanour ..."⁵⁷

The Supreme Court at one stage in U.S. v Grinnell Corp.⁵⁸ held that s.2 requires two elements:

(1) "the possession of monopoly power in the relevant market".

This is the threshold test and is remarkably similar to the Australian threshold of "a substantial degree of market power" and resembles New Zealand's Dominant Position threshold.

(2) "the wilful acquisition or maintenance of that power as distinguished from growth or development as a consequence of a consequence of a superior product, business acumen or historic accident".⁵⁹

The Supreme Court altered the second element in Aspen Skiing Co. v Aspen Highlands Skiing Corp.⁶⁰ to:

56 603 F. 2d 263 (2d Cir. 1979), cert. denied, 444 U.S. 1093 (1980).

57 15 U.S.C. § 2 (1988).

58 384 U.S. 563 (1966).

59 Id. at 570-571.

60 472 U.S. 585 (1985).

"the wilful acquisition, maintenance or use of that power by anticompetitive or exclusionary means or for anticompetitive or exclusionary purposes".⁶¹

The Grinnell second limb derives from Judge Learned Hand's famous⁶² decision in U.S. v Aluminium Co. of America⁶³ (Alcoa). Alcoa controlled 90 per cent of the aluminium ingot market. The Second Circuit held Alcoa breached s. 2 by doubling and redoubling its production capacity over 25 years to meet anticipated increases in demand before others had a chance to enter the market. The Court observed Alcoa "effectively anticipated and forestalled all competition and succeeded in holding the field alone".⁶⁴ The Court noted that "size does not determine guilt" and that "persons may unwittingly find themselves in possession of a monopoly".⁶⁵ It indicated a court would probably not find a breach of s. 2 if the firm had the monopoly "thrust upon it".⁶⁶ In discussing the requirements for breach of s. 2 Judge Hand stated:

"In order to fall within s. 2, the monopolist must have both the power to monopolise and the intent to monopolise. To read the passage as demanding any "specific" intent makes nonsense of it, for no monopolist monopolizes unconscious of what he is doing".⁶⁷

61 Id. at 605.

62 Robert Bork calls it infamous. R. BORK, THE ANTITRUST PARADOX : A POLICY AT WAR WITH ITSELF 428 (2d ed. 1993).

63 148 F. 2d 416 (2d Cir. 1945).

64 Id. at 430.

65 Ibid.

66 Id. at 429.

67 Id. at 423.

Cases following Alcoa took the position, a firm satisfied the deliberateness or general intent element of monopolisation if the monopoly was the probable result of what the firm did, as opposed to a situation that was thrust upon the firm.⁶⁸

These decisions show the conflicting principles in the second or deliberateness element of s. 2. On one hand s. 2 abhors monopoly power because of the danger it will lead to higher prices, lower output, poorer quality and less innovation. On the other hand a firm that competes through lower prices, higher output, better quality or more innovation may well thereby achieve or maintain a monopoly. This is simply a restatement of Judge Frank Easterbrook's views that competitive and exclusionary conduct look alike.⁶⁹

Judge Hand noted "[t]he successful competitor having been urged to compete, must not be turned upon when he wins".⁷⁰ Alcoa did not establish clear standards by which to distinguish predation from normal competition. It arguably suggested, that a firm with monopoly power might breach s. 2 by simply engaging in normal competitive conduct that is generally considered procompetitive, if the effect of such conduct is to enhance its market position.

68 See e.g., U.S. v Grinnell Corp., 384 U.S. 563, 576 n. 7 (1966) ("consciously acquired" monopoly obviates necessity to determine intent); U.S. v Paramount Pictures, 344 U.S. 131, 173 (1948) ("the requisite 'purpose or intent' is present if monopoly results as a necessary consequence of what was done"); U.S. v Griffith, 334 U.S. 100, 106 (1948) ("restraint or monopolisation" as "necessary and direct" of conduct).

69 Easterbrook, On Identifying Exclusionary Conduct, 61 NOTRE DAME L. REV., 972 (1986).

70 Supra, note 63, at 430.

Not surprisingly commentators have crucified the case.⁷¹

Latter decisions have generally held that lawfulness does not require that a firm be entirely involuntary or passive in acquiring or maintaining monopoly power. The Second Circuit Court of Appeals in Berkey Photo, Inc. v Eastman Kodak Co.⁷² held "... the "thrust- upon" phase does not suffice. It has been criticized by scholars ... and the Supreme Court seems to have abandoned it".⁷³

The Seventh Circuit has noted "... the possessor of lawfully acquired monopoly power ... is not forbidden from improving his efficiency in manufacturing or marketing, even through the effect of doing so will be to maintain or improve his sales".⁷⁴

U.S. Courts now try and categorize conduct that can form the basis of a s. 2 claim and distinguish it from conduct that should not. Courts characterize unlawful conduct as "anticompetitive", "predatory", exclusionary", "unreasonably restrictive", "abusive" or "directed at smothering competition". Courts describe lawful conduct as "competitive", "honestly industrial" or involving "legitimate business reasons". The High Court of Australia observed in QWI these labels do not clearly distinguish between predation and normal competition.⁷⁵

71 BORK, *supra*, note 62 at 165-170; P. AREEDA & D. TURNER, *ANTITRUST LAW*, para 729 (1978); In U.S. v Syufy Enterprise, 903 F. 2d 659, 668 (9th Cir. 1990). The Ninth Circuit observed Alcoa "had been questioned by just about everyone who has taken a close look at it".

72 *Supra*, note 56.

73 *Id.* at 274.

74 Sargeant-Welch Scientific Co. v Ventron Corp., 567 F. 2d 701, 712 (7th Cir.), cert. denied, 444 U.S. 1093 (1980).

75 *Supra*, note 12, at 50, 016 per Dawson J.

Similarly the Fifth Circuit has stated:

"There is obviously a tension inherent in the legal assignment to protect competition but not competitors. Fighting hard but fair, avoiding ruinous competition and avoiding predation are often used catch-words that fail in their central normative purpose - they do not segregate desired and undesirable conduct in the market place".⁷⁶

Although the various Circuits have slightly different tests for distinguishing predation and competition, the following generalisation seems to be correct. Courts find conduct predatory where it would be economically irrational for the monopolist but for its adverse impact on competition.⁷⁷ In contrast, more vigorous competition, or the aggressive pursuit of legitimate business objectives, is not generally improper, even for a firm with monopoly power and even where the conduct disadvantages its rivals.⁷⁸ The Circuits stress that a monopolist must be allowed to compete vigorously.⁷⁹

76 Adjustments Replace-A-Car, Inc. v Agency Rent-A-Car, Inc., 735 F. 2d 844, 888 (5th Cir. 1984), cert. denied, 469 U.S. 1160 (1985).

77 Advanced-Health-Care Services v Radford Community Hospital, 910 F. 2d 139, 148 (4th Cir. 1990) ("if a plaintiff shows that a defendant has harmed consumers and competition by making a short term sacrifice in order to further its exclusive anticompetitive objectives, it has shown predation by that defendant."); Instructional Systems Development Corp. v Aetna, 817 F. 2d 639, 649 (10th Cir. 1987) ("conduct constituting an abnormal response to market opportunities); Eureka Uethane, Inc. v PBA, Inc., 746 F. Supp. 915, 924 (E.D. Mo. 1990) ("Such conduct makes sense only because it eliminates competition ... To be labelled anticompetitive, the conduct involved must be such that its anticipated benefits were dependent on its tendency to discipline or eliminate competition... ").

78 Aspen, *supra*, note 60.

79 See, e.g. Abcor Corp. v AM International, Inc., 916 F. 2d 924, 927 (4th Cir. 1990) ("A desire to increase market share or even to drive a competitor out of business through vigorous competition on the merits is not sufficient"); U.S. v Syufy Enterprises, 903 F. 2d 659, 668-669 (9th Cir.

The test resembles the QWI test. If conduct is economically irrational for a monopolist, but for its effect on rivals, presumably it is only possible or commercially feasible for a monopolist to do.

The Second Circuit Court of Appeal's Berkey Photo⁸⁰ test is relevant. The Court established two tests to determine whether conduct was a use of monopoly power. First, a monopolist is liable if its conduct is impossible without monopoly power. The Court regards a competitive advantage made possible only by monopoly power to be use of monopoly power. However, a competitive advantage due to size or integration is not use of monopoly power. Thus, use of economies of scale and integration is lawful.

Second, a monopolist whose conduct has an exclusionary market effect, beyond what it would without market power. Thus, some acts, although both monopolists and rivals can do them, only harm competition when a monopolist commits them. The Court gave the example of predatory pricing, lease-only policies and exclusive buying.

The Berkey test does not automatically impose liability on an exclusive dealing or lease-only monopolist. A plaintiff still has to show intent and the monopolist can show no use by claiming its conduct was efficiency enhancing. The Supreme Court stressed efficiency when in Aspen⁸¹ it held: "If a firm has been "attempting to exclude rivals on some basis other than efficiency" it is fair

1990) ("an efficient, vigorous, aggressive competitor is not the villain antitrust laws are aimed at eliminating").

80 Supra, note 56.

81 Supra, note 60.

to characterize its behaviour as predatory".⁸² It also adopted the Areeda-Turner test of exclusionary (predatory) behaviour:⁸³

"Thus "exclusionary" comprehends at the most behaviour that not only (1) tends to impair the opportunities of rivals, but also (2) either does not further competition on the merits or does so in an unnecessarily restrictive way".⁸⁴

The Eighth Circuit Court of Appeals in Trace-X Chemical Inc. v Canadian Industries Ltd⁸⁵ has enunciated the difference between acceptable and illegal conduct by a monopolist, in very similar terms to the QWI test. The case involved a monopolist's refusal to extend credit or replace defective material. The Court held:

"[A]cts [by a monopolist] which are ordinary business practices typical of those used in a competitive market do not constitute anticompetitive conduct violative of section 2".⁸⁶

This is exactly the same as the QWI test. Thus, U.S. law is relevant.

New Zealand:

Initially, the High Court paid little attention to the "use" element. Tipping J. in New Zealand Magic Millions Ltd v Wrightson Bloodstock Ltd⁸⁷ held:

"As a first observation I would have thought that if a person having a dominant position acts in a particular way with a prohibited purpose in mind it is almost axiomatic that such person

82 Id. at 605.

83 AREEDA & TURNER, *supra*, note 71, at 78.

84 *Supra*, note 60, at 605.

85 738 F. 2d 261 (8th Cir. 1984), cert. denied, 469 U.S. 1160 (1985).

86 Id. at 266.

87 *Supra*, note 1.

has used his dominant position for a prohibited purpose ... It seems to me that the key question is not so much whether a dominant party has used its dominant position but rather whether or not its conduct is proved to have been for one of the proscribed purposes ...

I would venture the following proposition. It is not a breach of s. 36 if a person, albeit with a dominant position, simply acts in a competitive manner. It would be an irony if such conduct could be attacked because it is competition which the Act is designed to promote. However, if someone with a dominant position takes some action for a purpose proscribed by s. 36 then clearly they are using their dominant position in a manner which s. 36 prohibits. The line may well be a fine one in certain cases but it will be a matter of fact and degree and ultimately of judgment in the individual case whether the line between what one might call legitimate competition and illegitimate competition has been crossed".⁸⁸

This interpretation places virtually no significance on the "use" element of s. 36.

The High Court in Union Shipping New Zealand Ltd v Port Nelson Ltd⁸⁹ differed and emphasised the "use" element.

The case involved the Port Company imposing a levy on a shipping company and an associated stevedoring company which wanted to use the port. The shipping company claimed this breached (inter alia) s. 36. A key element of the defence was that a combination of economies of scale and high transaction costs made all cargo handling activities at the port a natural monopoly. In short the port company did not use its dominant position. The High Court observed:

"Section 36 provides that no person who has a dominant position in a market shall use that position for proscribed purposes. There must be 'use' of dominant position for infringement. The section does not say that no person who has a dominant position in a market shall 'act' for proscribed purposes. The evidence of Dr

88 Id. at 761.

89 [1990] 2 NZLR 662.

Williams and the submissions for Port Nelson Ltd took the stance that there is no 'use' of dominant position where a person simply is doing something which would be done in a competitive situation in any event. Put so baldly, and as a theoretical proposition, few would disagree. If a person simply acts in a normal competitive fashion, as he would whether dominant or not, that person hardly can be said to be 'using dominance'. Port Nelson Ltd in its submission seeks to build on this proposition, through Dr Williams' theory of expansion through economies of scope, to a position where it is said Port Nelson Ltd demands for use of its own forklifts or additional payments are steps Port Nelson Ltd would take in a normal competitive situation, irrespective of dominance. Ultimately this is a question of fact."⁹⁰

In resolving this question of fact the Court discussed the competitive pressures Port Nelson would face in a competitive market and concluded:

"We do not accept that in imposing a requirement for plant hire, or additional payment, Port Nelson Ltd is acting as it would in a competitive situation, and is not using its dominant position. Its present demands are possible only because of its dominant position. Its demands, at time stark, are a use of that dominance".⁹¹

The High Court's test is consistent with the QWI test and the Trade Practices Commission's formulation of the QWI test. Although the High Court did not quote QWI when discussing use it referred extensively to it when dealing with dominance and purpose.

The next and most important New Zealand case is Electricity Corp. Ltd v Geotherm Energy Ltd.⁹² Geotherm an intending producer of electricity in the central North Island, claimed that Electricorp (which was allegedly dominant

90 Id. at 706.

91 Id. at 707.

92 Supra, note 12.

in that market) had breached s. 36⁹³ by -

1. Making public statements calculated to deter customers, financiers and investors from dealing with its competitors.
2. Objecting to Geotherm's statutory applications at every opportunity and on all possible grounds. Geotherm alleged many of Electricorp's applications were baseless and that Electricorp had led perjured evidence and had assisted other objectors.
3. Entering into contracts with electrical supply authorities which prevented competition for electrical supplies.
4. Attempting to influence key specialists too withhold services from Geotherm.

In essence, Geotherm claimed Electricorp had a policy to exclude all competitors.

Electricorp sought to have the Statement of Claim struck out. It was unsuccessful before Barker J. in the High Court.⁹⁴ The case went to the Court of Appeal. Both parties agreed that the pricing contracts could be a breach of s. 36.⁹⁵ The Court of Appeal would have been happy to have left the Statement of Claim because the public statements and objections etc. were relevant in ascertaining Electricorp's purpose.⁹⁶ However, the Court also considered whether such conduct could amount to "use" of Electricorp's

93 Id. at 644 and 645.

94 Unreported, HC, Auckland, C P 1248/91; 193/92.

95 Supra, note 12 at 647.

96 Ibid.

dominant position.

The Court clarified the "use that position" element of s. 36. The Court confirmed it was analytically separate from the "purpose" element and that a plaintiff had to prove both:

"The conduct prohibited by the section is the use of the dominant market position for the proscribed purposes. There will be circumstances in which the use of the market position and the purpose are not easily separated but the two requirements must be kept in mind".⁹⁷

The Court held "to use" that [dominant] position would be actually to exercise or attempt to exercise a dominant influence over production, acquisition, supply and price of goods or services in their relevant market. "That ... may be done directly or indirectly in many ways ... and the effects or potential effects of particular conduct will be determined only on a close assessment of the market ...".⁹⁸

The Court looked to s. 46 of the Australian Trade Practices Act and held it may not be directly comparable.

"[W]e are not satisfied that use of a market position necessarily is the same as use of market power. It is arguable that use of a dominant position is to be construed as use of the market power flowing from that position. But equally a position in which unconstrained discretionary conduct is open may be used without engaging in that conduct as by threatening to do so".⁹⁹

Use of that position is not confined to market activity in the production, acquisition, supply and price of goods and services. It extends to conduct

97 Id. at 646-647.

98 Id. at 648.

99 Id. at 649.

capable of influencing those market elements. There must however be a clear and direct link between the influence and the dominant position. Finally, the Court quoted from Hampton.¹⁰⁰

"Although s. 3(8)(a)-(c) contains a non exhaustive list of factors that aid in market power analysis, one must bear in mind that the concept of market power employed in s. 3(8) extends beyond the narrow economic notion, viz, the ability of a firm to profitably raise price above marginal cost. The s. 3(8) test is whether a firm "is in a position to exercise the dominant influence over the production, acquisition or supply or price of goods or services in a market. This expansive notion of market power would embrace rights, powers or advantages that enable the firm to exercise a major influence over one or more of the market variables mentioned. Assuming such rights etc. contribute to the firm's dominance, then taking advantage of such rights will involve the "use" of the firm's dominant position".¹⁰¹

The Court's overall approach endorses the view that s.36 covers conduct which only a dominant firm could perform.

This is entirely in line with the QWI test. Indeed the Court of Appeal endorsed the QWI approach:

"The interpretation of s. 46 adopted by the High Court of Australia indicates a similar approach to that dictated by the New Zealand s. 36".¹⁰²

It further noted:

"The actual conduct under scrutiny in that case [QWI] was refusal to supply goods. That could have been done by a supplier with a single customer. It was not the conduct itself that amounted to a use of market power for the prohibited purpose but the conduct in the market context for the particular anticompetitive

100 Hampton, *supra*, note 3.

101 *Supra*, note 12 at 650.

102 *Id.* at 649.

purpose".¹⁰³

Electricorp's conduct only made commercial sense or could be financially viable because it was a dominant firm. Having set out its views on the constituent elements of s. 36 the Court considered each allegation separately.

1. Statements of Policy:

Electricorp had apparently made public statements that it had a policy to retain its virtual monopoly and it intended to take steps to deter potential competitors and customers. Electricorp allegedly said it would lower its charges in order to meet any competition. The Court held such statements could breach s. 36 and whether they did in this case had to be determined on the evidence. It noted -

"[W]e are not satisfied that statements made on behalf of a company in a dominant position as to the intended exercise of market power to deter potential competitors made in circumstances that make them in fact likely to deter competition could not fall within s. 36. Such statements may be said to "use" a dominant position if it is the dominant position that gives the statements the force amounting to deterrence".¹⁰⁴

With respect this seems to be correct. Such statements could deter competitors and customers. A firm's dominance gives these statements serious force. Its economic resources ensure it will be able to back up its policy effectively. Such statements could deter investment. One can extend this reasoning to threats of litigation. This too, could discourage investment. Again

103 Ibid.

104 Id. at 650.

dominance gives the threats serious force. The statements will have extra deterrence if the dominant firm has a reputation for successfully preventing firms from competing with it. They may also raise the potential entrant's costs as it is likely to seek legal advice in evaluating the threats. A nondominant firm is unlikely to have such a reputation and be able to afford to back up the statements as effectively.

Statutory Approvals:

Electricorp argued that exercising statutory rights of objection can never be a breach of s. 36. Geotherm said it objected about the way Electricorp exercised these rights, namely the alleged perjury, over reaching grounds of opposition and assisting other objectors. The Court rejected Electricorp's contentions and was not prepared to say that exercising statutory rights could not be a use of s. 36. It said "... it can be argued with some strength that the exercise of statutory rights will not necessarily be beyond the scope of the New Zealand s. 36".¹⁰⁵ The Court noted that if

"... technical knowledge and access to material and capital [factors which indicate whether a firm can influence price, acquisition, production and supply and thus have a dominant position in the market]" are an element of a dominant position and are used in the course of the exercise of statutory rights for a proscribed purpose, s. 36 might be breached".¹⁰⁶

Again with respect, this appears to be correct. The purpose of predatory litigation is to increase costs and to delay or prevent entry. Achieving this can

105 Id. at 651.

106 Ibid.

influence price, acquisition, production and supply of goods and services. The Court rejected the argument that allowing objections to be a breach of s. 36 would mean a rehearing of all the statutory objections.

The Court did not think that exercise of reasonable rights of objection could contravene s. 36.

"[A] monopoly is entitled to make a case to the appropriate licensing or other authority for the preservation of its monopoly. The submission of reasonable arguments to that end and the taking of reasonable steps to prepare the case could not in themselves amount to use of a dominant position in the market. Something more would have to be shown to bring Electricorp (a dominant firm's) conduct within s. 36".¹⁰⁷

The Court could not discount that possibility so it refused to strike out the Statement of Claim.

It is necessary to examine what factors led the Court of Appeal to conclude this. Geotherm alleged the following:-

- (i) The statutory objections were part of a larger anticompetitive scheme.
- (ii) Electricorp had committed perjury and made misrepresentations during the hearings of the statutory objections.
- (iii) Electricorp had assisted other objectors.
- (iv) Electricorp's objections were in many cases baseless.
- (v) Electricorp objected at every stage on all possible grounds.

This was the "something more" the Court of Appeal referred to.

¹⁰⁷ Id. at 655.

A nondominant firm can make reasonable arguments and take reasonable steps in preparing a case. "Reasonable arguments" suggests that the firm making them wants to, or at least, has a chance to win. A firm that makes unreasonable arguments cannot win. A firm in a competitive market could not afford to waste money on a case it could not win. Similarly, it would not be able to afford to object regardless of the merits or afford to assist other objectors. The above facts are also relevant to purpose. A firm which brings a case it cannot win must have a purpose other than winning. This must be to harm the other party.

Thus, had Electricorp not been dominant it could have acted as it did. This is in line with the U.S. Courts' view that conduct is predatory if it would be economically irrational for the monopolist, but for its adverse impact on competition.¹⁰⁸ Such conduct would be irrational for Electricorp if it was in a competitive market.

In the High Court Barker J. recognised that although each separate incidence of Electricorp's conduct may not amount to "use" when considered together they could be a use, i.e. Electricorp's policy of excluding Geotherm could be a use.¹⁰⁹ This is in line with the U.S. Seventh Circuit Court of Appeals.¹¹⁰ There, even where no single act of a monopolist is an act of monopolisation, a group of acts, in aggregate, can violate s. 2. The Court terms this the "monopoly broth".

108 See, *supra*, note, 77.

109 *Supra*, note 94.

110 City of Mishawaka v American Electric Power Co., 616 F. 2d 976 (7th Cir. 1980), cert. denied, 449 U.S. 1096 (1981).

"[W]e might agree with the [defendants] that no one aspect standing alone is illegal. It is the mix of the various ingredients of [defendants'] behaviour in a monopoly broth that produces the unsavory flavour".¹¹¹

The "monopoly broth" concept still meets the QWI test. Electricorp's policy was only possible and only made sense because of its dominance.

Subsequent New Zealand Courts have adopted the Electricorp and QWI reasoning. The High Court in Clear Communications Ltd v Telecom Corp of NZ Ltd¹¹² commented on Telecom's conduct that:

"It is obvious that Telecom could only do this by use of its dominant position in the market".¹¹³

The Court of Appeal in Telecom¹¹⁴ adopted the QWI test:

"To determine whether particular conduct involves use of a dominant position in a market for any of the purposes specified in s. 36 has been said to require consideration of whether the conduct would have been open if the party concerned were [sic] not in a dominant position - if it were [sic] in a fully competitive market. Such a test reflects the underlying purpose of the section which is to promote competition. Even monopolists are entitled to act competitively and the section must not be applied so as to constrain them".¹¹⁵

The Court re-emphasised its comment in Electricorp that a court must consider the conduct in its commercial context.

Thus, New Zealand courts now require that a dominant firm's conduct be

111 Id. at 986. See also City of Groton v Connecticut Light & Power Co., 662 F. 2d 921, 929 (2d Cir. 1981) ("the proper inquiry is qualitatively, there is a 'synergistic' effect").

112 1993 5 TCLR 166.

113 Id. at 208.

114 Unreported 17/12/93 CA 25/93.

115 Id. at 24.

only possible or commercially sensible because of the lack of a competitive market, before that conduct is a "use" of a dominant position. However, a number of cases have ignored the use limb and concentrated solely on the purpose limb. These cases arose out of the New Zealand Milk Corporation and other milk suppliers terminating groups of milk vendors' contracts to deliver milk. The Corporation entered into these pursuant to the Milk Act 1988. The Milk Act was due to expire from 1 April 1993. In late 1992 the Corporation gave notice to its vendors of a new franchised vendor home delivery scheme. This was to come into effect from 1 February 1993, i.e. 2 months before the Milk Act expired. The Corporation reduced the number of licensed vendors considerably. The new franchisees would have exclusive rights to sell milk within defined zones. The existing vendors had the right to apply for one of the franchises. The unsuccessful ones were entitled to an "exit payment" provided they agreed not to compete against franchisees for 6 months from 31 January 1993. They also had to supply customer details.¹¹⁶

The unsuccessful vendors sought injunctions alleging (inter alia) breach of s. 36. None of the cases discussed use, but dealt with whether the Corporation and other suppliers had an anticompetitive purpose. While the cases were interlocutory and thus, only have a limited precedent effect both, J.

116 New Zealand Milk Corp. Ltd v McDonald [1993] 2 NZLR 543; Hyde v Topmilk Ltd, unreported, 3/11/92, Whangarei, CP 52/92, Penlington J.; Byers v Northland Dairy Products Ltd, unreported, 10/12/92, Whangarei, CP 65/92, Blanchard J.; Nicholls & Holmes Ltd v Intermilk Ltd, unreported; 25/5/92, Auckland, CP 225/92, Thorp J.; Wellington Provincial Milk Vendors Association v Manawatu/Rangitikei Milk Vendors Association, unreported, 27/10/92, Wellington, CP 681/92, Neazor J.

Blanchard in Byers v Northland Dairy Products Ltd¹¹⁷ and Penlington J. in Hyde v Topmilk Ltd¹¹⁸ approvingly cited Tipping J's comments on use in Magic Millions. Penlington J. held:

First, the conduct under attack must have had an anti competitive purpose. Mere use of a dominant position without having the purpose prescribed by s. 36 does not result in a breach of the section. Tipping J. expressed the point with the utmost clarity in Magic Millions v Wrightson Bloodstock [1990] 1 NZLR 731 esp at p 761 where his Honour said:

"It seems to me that the key question is not so much whether a dominant party has used its dominant position but rather whether or not its conduct is proved to have been for one or more of the proscribed purposes."¹¹⁹

With respect, Tipping J's comments on use can no longer be the law following the Court of Appeal's comments in Electricorp.

A number of unresolved issues remain over the "use" element. I examine each of these.

Efficiency and Use

Frances Hanks and Doctor Philip Williams argue that QWI means that if a firm's conduct promotes efficiency it cannot be a use of a dominant position.¹²⁰ They argue that:

"The effect of the decision of the High Court in QWI is to

117 Supra, note 116, at 21.

118 Supra, note 116, at 49.

119 Ibid.

120 Hanks & Williams, Implications of the Decision of the High Court in Queensland Wire, 17 MULR, 437 (1990).

encourage parties to argue efficiencies before the courts. Far from introducing value judgements into the section, the construction places economic efficiency at the heart of s. 46".¹²¹

Michael O'Bryan agrees.¹²² He argues the High Court placed its greatest emphasis on the "take advantage" element of s. 46 which means economics is the key to s. 46 analysis.¹²³

The QWI test, is that a firm has not used its dominant position if it would engage in the same conduct in a competitive market. In a competitive market a firm has actual or potential rivals. Rivals force the firm to improve productive efficiency. No one firm has the ability to do its own thing or ignore its rivals. Rivals restrain the firm's market power. They can offer or threaten to offer a new product, a cheaper product or a more effective product. Thus, to maintain or improve its market share the firm must improve its productive efficiency.

If a dominant firm's conduct improves its productive efficiency, it is acting the same way as it would in a competitive market. It has not used its dominant position. With respect, the argument is compelling. Professor Maureen Brunt has commented:

"In any event, one would think from a commonsense viewpoint that to interpret "taking advantage" as conduct that would not be possible or commercially sensible under competitive conditions would point directly to the relevance of evidence on efficiencies likely to result from the conduct at issue".¹²⁴

121 Id. at 444.

122 O'Bryan, Section 46 : Law on Economics?, 1 CCLJ 64 (1993).

123 Id. at 64.

124 Brunt, Australian and New Zealand Competition Law and Policy, in 1992 FORDHAM CORPORATE LAW INSTITUTE PROCEEDINGS, 131, 170.

New Zealand Courts seem to have adopted the argument. Port Nelson¹²⁵ is an apposite example. The defendant's argued that its wharf use levy was due to its economics of scale and it being a natural monopoly. The High Court accepted the argument in theory.

"We can accept that in a search for economies of scope, reaching out to insert plant and drivers into a new range of activities, [the defendants] might (indeed probably would) think it desirable to require stevedores to use PNL plant, or make additional payments thereby assisting PNL with such economies".¹²⁶

The Court held that whether the levy achieved efficiencies was simply a "question of fact".¹²⁷

As a matter of fact, the Court held it was not. It held that Port Nelson was seeking to charge a level and structure of rates that was more than the "commercially reasonable".¹²⁸ Thus, the levy per se was not use of a dominant position. It was the amount of the levy. It was too high for Port Nelson to achieve its efficiencies. It could have achieved them at a lower level. The means Port Nelson used to obtain the efficiencies were unnecessarily restrictive. It could have obtained them in a less restrictive way. It could only claim the amount of the level because of its dominant position. It could not have obtained such a high levy had the market been competitive. The case is consistent with the U.S. Supreme Court's decision in Aspen.¹²⁹ The Court expressly adopted

125 *Supra*, note 89.

126 *Id.* at 706.

127 *Ibid.*

128 *Id.* at 710.

129 *Supra*, note 60.

the Areeda-Turner definition of predation; viz:

"Behaviour that not only

- (1) tends to impair the opportunities of rivals, but also
- (2) either does so in an unnecessarily restrictive way".¹³⁰

The High Court said the advisable relief was to undertake a proper cost analysis of the levy to ascertain a commercially acceptable level. Thus, the Court accepted the efficiency argument. It held the means the defendant sought to achieve the efficiencies (the levy) was acceptable. The level of the levy was however not. Thus, as a matter of fact the defendant used its dominant position.

The High Court in Clear Communications Ltd v Telecom Corp. of New Zealand Ltd¹³¹ accepted the argument. Briefly the facts were that Telecom was the former monopoly telecommunications service provider. The government privatised it and deregulated the telecommunications industry. Clear is a new entrant to the market. It sought entry in the market for local calls. One of the main issues was what price Clear should pay for interconnection into the market. Telecom, after changing its stance, offered supply on the basis of the Baumol-Willig rule. This rule allowed Telecom to charge Clear an amount equal to Telecom's lost revenue as a result of Clear's interconnection, i.e. it wanted to recover its opportunity costs in allowing Clear access. Clear argued and the Court accepted that the Baumol-Willig rule allowed Telecom to charge monopoly prices. The rule forced Clear to underwrite Telecom's existing monopoly profits and inefficiencies. The Court could not determine Telecom's

130 Id. at 605.

131 Supra, note 112.

monopoly profits and inefficiencies on the evidence.

The High Court held that the Baumol-Willig rule was consistent with what a firm could charge in a competitive market. It said:

"In the end it is our judgment that implementation of the Rule is more likely than the alternatives to improve efficient competition in New Zealand telecommunications. In that case, Telecom cannot be said to be using its position of dominance for the purpose of preventing or deterring Clear from engaging in competitive conduct in the New Zealand telecommunications market. If the defendant's conduct is more likely than not, in light of available alternatives, to improve competition, the defendant cannot be said to be in breach of the purpose requirements of s. 36. There is an improvement in competition when there is an enhancement of an efficient competitive process. (emphasis added)".¹³²

Thus, the High Court expressly adopted the view that if a dominant firm's conduct enhanced efficiency it would not be using its dominant position.

The Court of Appeal reversed.¹³³ It did not discuss the use element. The Court stressed that any pricing rule which incorporates monopoly profits breaches s. 36. It held it could infer from the evidence that the Baumol-Willig rule did incorporate monopoly profits. Thus, as with Port Nelson the Court of Appeal found as a matter of fact the dominant firm's conduct did not improve efficiency. The Court emphasised that efficiency was at issue in the case.¹³⁴ With respect, this seems correct. I shall argue later that monopoly profits in such circumstances and efficiency are mutually exclusive.¹³⁵ Thus, the Court

132 Id. at 132.

133 Supra, note 114.

134 Id. at 37.

135 See Chapter VI, *infra*.

does not rule out the view that efficiency has a role to play in interpreting the "use" element. The Court's only comments on use were as follows:

"[The High Court] suggests that so long as there is overall some improvement in the competitive process there can be no breach of s. 36. However if, but for the conduct in question, there would have been significantly greater enhancement of the competitive process the conduct may well contravene the section".¹³⁶

The Court did not define what it meant by the competitive process. If it means consumer welfare, then efficiency plays the key role. The dominant firm's conduct may enhance efficiency, but if some other conduct will lead to even greater efficiency or if the conduct is unnecessarily restrictive, then s. 36 is breached. However, one could interpret the above comments as meaning the competitive process equates with rivalry. Thus, if a monopolist's conduct impedes a rival then the section will be breached - no matter what the effect on consumer welfare. I will discuss this point later when discussing whether s. 36 deals with injury to rivals or competition. I will argue the latter and say the Act, previous authority and economics compels this conclusion.

It thus, appears efficiency is a part of "use" under s. 36. What Port Nelson and Clear show, is that courts will not automatically accept a dominant firm's efficiency defence. It will carefully evaluate it.

Another related issue is whether the protection of a dominant firm's property rights comes within the use and efficiency umbrella. The concept of protection of property rights arises as follows. A dominant firm will make investments in creating a property right. This includes such things as building stockyards, creating a reputation for its product and building a bridge. A rival

136 Supra, note 114, at 37.

may try and benefit from the dominant firm's actions, efforts and investments without paying or sharing the costs. In this way the rival free rides on the dominant firm's investments. Free riding harms efficiency by reducing or eliminating the dominant firm's incentive to make its investments.¹³⁷ Without these investments consumer welfare will suffer as the dominant firm will sell less of its product or not develop new ones. In the s. 36 context this most commonly arises when a rival seeks access to a dominant firm's product or facility. The dominant firm may seek to charge for its use or refuse to supply, to prevent free riding. While New Zealand courts have addressed free riding under s. 27 not s. 36 the authorities support the notion it is relevant to use. For example, in Port Nelson¹³⁸ the High Court held the Port Company could impose a levy. It held the amount breached s. 36. It ruled the parties should undertake a proper cost analysis to establish a commercially acceptable level. Such a level must include a fee to compensate the Port Company for its investments and to prevent free riding.

Similarly, some of the Court of Appeal's comments in Clear¹³⁹ support property rights being important under s. 36. The Court held Clear had to pay an access levy. Cooke P. stated "that Telecom is entitled to a fair commercial return for granting Clear use of the network assets without regard to present

137 Telser, Why Should Manufacturers Want Fair Trade?, 3 J.L. & ECON., 86 (1960); R. BLAIR & D. KASERMAN, ANTITRUST ECONOMICS, 171-172, 351-353 (1985); R. POSNER, ANTITRUST LAW : AN ECONOMIC PERSPECTIVE, 208-211 (1976).

138 Supra, note 89.

139 Supra, note 114.

monopoly".¹⁴⁰ A fair commercial return must include compensation for Telecom having bought its network assets and any improvement it made to them.

This is in line with the U.S. authorities on essential facilities. An entrant has to pay a reasonable access fee.¹⁴¹ Once again this must include compensation for the monopolist having developed the essential facility.

Similarly, where more than one facility exists the owner of the best does not have to give access to rivals. Protection of private property is one reason. Indeed, in Dowling,¹⁴² Lockhart J. held that the association was allowed to use the stockyards as it saw fit and not to share it with persons who had no proprietary interest in it. The association presumably wanted to prevent free riding. U.S. Courts have reached the same conclusions in American Football League v National Football League¹⁴³ Judge Clement Haynsworth said:

"It frequently happens that a first competitor in the field will acquire sites which a latecomer may think more desirable than the remaining available sites, but the first comer is not required to surrender say, or all of its desirable sites to the latecomer simply to enable the latecomer to compete more effectively with it".¹⁴⁴

Although I have argued that dynamic efficiency is too uncertain to be relevant under s. 36, protecting private property and preventing free riding aids dynamic efficiency. Allowing free riding will discourage innovation. Why will

140 Id. at 7.

141 Note, Unclogging the Bottleneck: A New Essential Facilities Doctrine, 83 COLUM. L. REV., 441 (1983).

142 Supra, note 41.

143 323 F. 2d 124 (1963).

144 Id. at 131.

a firm innovate if its rivals can free ride on its investment in research and development? It won't. The encouragement of innovation, by preventing free riding, is the entire basis of granting patents.

Thus, protecting of private property and preventing free riding is part of efficiency and use under s. 36.

The result of treating efficiency as part of the use limb downplays the purpose limb of s. 36. If a dominant firm's conduct enhances efficiency it will never meet the use limb. Thus, it will not breach s. 36. On the other hand if a dominant firm's conduct reduces efficiency it will be extremely difficult to show its purpose was not anticompetitive.

Some commentators have seized on the downplaying of purpose and argue "use" means something less than conduct only possible or commercially sensible in the absence of competition.

Yvonne van Roy¹⁴⁵ and Janet November¹⁴⁶ building on work by Vogelenzang and Hampton argue the QWI test is too wide. They argue although one must show a causal connection between the dominant position and use the connection is not the QWI "but for" test; viz, the dominant firm's conduct was not possible or sensible but for its dominant position. They argue two main types of "use of a dominant position" exist.

1. Conduct which only a dominant firm can perform. They call this the

145 Van Roy in GAULT ON COMMERCIAL LAW, para 36.07(3).

146 November, The Meaning of Use of a Dominant Position : From Queensland Wire to Electricity Corp. v Geotherm Energy, 23 VUWLR 191 (1993).

narrow QWI test.¹⁴⁷

2. Conduct which any firm can perform but the effect on market conditions would not occur or be treater if the firm were not dominant. They call this the broad QWI test.¹⁴⁸

The second type covers conduct possible by anyone, but the firm's dominance magnifies the conducts effect.

They argue that the purpose limb determines liability.¹⁴⁹ Once the conduct falls into the two above types, a defendant has established the use limb. A court then determines liability by examining purpose. Van Roy argues the trouble with the QWI test is that it will not catch things, such as refusal to supply or price cutting, as nondominant firms can perform them for various reasons. She claims that every case of refusal to supply by a dominant firm will be a use of a dominant position. The firm's dominance will magnify the refusal's effects. She argues courts should determine liability under the purpose limb.¹⁵⁰ Presumably, a refusal to supply because the customer is a poor credit risk, will be lawful as no anticompetitive purpose exists. The problem with this is that the Federal Court in Boral held that such a refusal is not a use of a dominant

147 Id. at 196. Van Roy repeats November's argument.

148 Id. at 197. They build on an analysis originally done by Vogelenzang, and Hampton; Vogelenzang, Abuse of a Dominant Position in Article 86 : The Problem of Causality and Some Applications, CMLR 61, 66 (1978); Hampton, *supra*, note 3, at 198-199.

149 Van Roy, *supra*, note 145; November, *supra*, note 146, at 198-199.

150 Van Roy, *supra* note 145.

position.¹⁵¹

November and van Roy claim Electricorp shows that the use element incorporates their two types of use of a dominant position.¹⁵² I have argued above that Electricorp is consistent with the "narrow" QWI test. Subsequent courts, including the Court of Appeal in Clear, have adopted the narrow test.¹⁵³ It is part of the s. 36's jurisprudence.

The other problem with the broad QWI test is that it does not adequately distinguish between predation and normal competition. Hampton rejects the test as it captures "ordinary business practices typical of those used in a competitive market".¹⁵⁴ He argues the Berkey Photo¹⁵⁵ test is the appropriate test. This test does not impose liability for use of scale economies and vertical integration. As Hampton notes: "It is not a violation of s. 2, however, for a company lawfully possessing monopoly power simply to enjoy the benefits such as efficiency and integration which naturally flow from its size but which may coincidentally damage a competitor".¹⁵⁶

Van Roy and November's broad QWI test for use, would mean that such use of efficiencies and integration would be a use of a dominant position. They claim the purpose limb will determine liability. However, they rely too heavily

151 Supra, note 46.

152 Van Roy, supra, note 145; November, supra, note 146, at 207-209.

153 See text accompanying notes 117-119, *infra*.

154 Hampton, supra, note 3, at 199.

155 Supra, note 72.

156 Hampton, supra, note 3, at 200.

and place too much confidence in purpose being able to distinguish between predation and competition.

Purpose:

The Utility of Purpose:

As mentioned above, the aim of s. 36 is to distinguish predation from normal competitive behaviour. One must ask how useful purpose is in distinguishing. U.S. commentators and courts have argued it is not useful at all. Judge Frank Easterbrook, in AA Poultry Farms Inc. v Rose Acre Farms Inc.,¹⁵⁷ has stated that courts should ignore questions of purpose in deciding monopolisation cases. He argued that a firm's purpose to harm its competitors is indistinguishable from its purpose to compete. Thus, looking only for the purpose to harm competitors invites courts to penalise hard competition. He suggested "firms intend to do all the business they can to crush rivals if they can".¹⁵⁸ He added " ... [I]f courts use the vigorous nasty pursuit of sales as evidence of forbidden 'intent' they run the risk of penalizing the motive forces of competition".¹⁵⁹

He went further in Ball Memorial Hospital v Mutual Hospital Insurance¹⁶⁰ by saying a competitors "intent to harm rivals is not a useful

157 881 F. 2d 1396 (7th Cir. 1989), cert. denied, 494 U.S. 1019 (1990).

158 Id. at 1401.

159 Ibid.

160 784 F. 2d 1325 (7th Cir. 1986).

standard in antitrust".¹⁶¹

Professor Harold Demsetz thinks the same.¹⁶² Former Judge and Professor Robert Bork also is sceptical about purpose being useful in distinguishing between predation and normal competition. He comments on Justice White's view in Standard Oil Co. of New Jersey v U.S.¹⁶³ and U.S. v American Tobacco Co.¹⁶⁴ that courts can distinguish the two on the basis that predation involves an intent "to drive others from the field and to exclude them from their right to trade";¹⁶⁵

"This is about as useful as defining normal sexual conduct as that engaged in to express love and abnormal sexual conduct as that engaged in for personal gratification. Whenever a competitor competes he intends to take business away from rivals, which involves excluding them. If he were completely successful in a market, he would thereby exclude them completely, and he would have intended to do so. Some test other than an intent to exclude must be framed".¹⁶⁶

Similarly, Areeda and Turner have commented on the limitations of using purpose or intent to distinguish predation from vigorous competition.

"[T]he antitrust appraisals of conduct depends upon understanding its possible anticompetitive consequences and its possible benefits for effective competition. Often the benefits will not be apparent or persuasive unless the defendant identifies his purpose in so acting, shows the legitimacy of that purpose in terms of antitrust objectives and suggests that the challenged action is an appropriate and perhaps the least restrictive way of achieving that legitimate

161 Id. at 1340.

162 Demsetz, Barriers to Entry, 72 AM. ECON. REV. 45 (March 1992).

163 221 U.S. 1 (1911).

164 221 U.S. 106 (1911).

165 Id. at 181-183.

166 BORK, *supra*, note 62, at 38-39.

purpose. But the critical point is that the nature and consequences of a particular practice are the vital consideration not the purpose or intent".¹⁶⁷

While Easterbrook and Bork are correct in that purpose alone does not adequately distinguish predation from competitive behaviour, the problem does not arise under s. 36. Section 36 requires proof of use and purpose. Purpose alone does not establish liability under s. 36. Despite Easterbrook's views, purpose alone never amounts to s. 2 liability. The First Circuit Court of Appeals in Ocean State Physicians Health Plan v Blue Cross and Blue Shield¹⁶⁸ noted that: "desire to crush a competitor standing alone, is insufficient to make out a violation of the antitrust laws".¹⁶⁹ Similarly the Second Circuit in United States Football League v NFL¹⁷⁰ held: "hopes and dreams alone cannot support a section 2 claim of monopolization".¹⁷¹ Intent, however, helps determine whether conduct is predatory. Only general - not specific intent is necessary.¹⁷² The Supreme Court acknowledged in Aspen Skiing Co. v Aspen Highlands Skiing Corp.¹⁷³

"evidence of intent is merely relevant to the question whether the

167 P. AREEDA & D. TURNER, ANTITRUST LAW, para. 729 (1978).

168 883 F. 2d 1101 (1st Cir. 1989), cert. denied, 494 U.S. 1027 (1990).

169 Id. at 1113; see also Olympia Equipment Leasing Co. v Western Union Tel. Co., 797 F. 2d 370, 379 (7th Cir. 1986) ("if conduct is not objectively anticompetitive the fact that it was motivated by hostility to competitors ... is irrelevant), cert. denied, 480 U.S. 934 (1987).

170 842 F. 2d 1335 (2d Cir. 1988).

171 Id. at 1359.

172 U.S. v Grinnell Corp., 384 U.S. 563 (1966).

173 472 U.S. 585 (1985).

challenged conduct is fairly characterised as 'exclusionary' or 'anticompetitive' - to use the words in the trial court's instructions - or 'predatory' to use a word that scholars seem to prefer. Whichever label is used there is agreement on the proposition that 'no monopolises unconscious of what he is doing'. As Judge Bork stated more recently: 'Improper exclusion (exclusion not the result of superior efficiency) is always deliberately intended'.¹⁷⁴

More recently the Seventh Circuit explained:

"But we have to be clear about what is meant by "intent", for in the context of a monopolization case "intent" is an elusive concept. The "intent" to achieve or maintain a monopoly is no more unlawful than the possession of a monopoly. Indeed, the goal of any profit-maximizing firm is to obtain a monopoly by capturing an ever increasing share of the market ... Monopolies achieved through superior skill are no less intentional than those achieved by anticompetitive means (as Learned Hand observed, "no monopolist monopolizes unconscious of which he is doing"), so the intent relevant to a § 2 Sherman Act claim is only the intent to maintain or achieve monopoly power by anticompetitive means. Section 2 forbids not the intentional pursuit of monopoly power but the employment of unjustifiable means to gain that power".¹⁷⁵

With respect to Easterbrook and Bork, they frame the purpose test too narrowly. Predation does not involve the purpose to crush one's rivals. The purpose required for liability should be the dictionary definition of plan or design. Thus, the purpose at issue is more complex than the simple object to crush one's rivals. While that purpose is indistinguishable from a purpose to compete vigorously, the purpose of strategic predation is the plan to disadvantage one's rivals. To make a rival's product less attractive. A predator may do so by raising rivals' costs. A purpose to do this is completely different

174 Id. at 602.

175 Illinois ex rel. Burris v Panhandle E. Pipe Line Co., 935 F. 2d 1469, 1481 (7th Cir. 1991) (footnote omitted) (emphasis in original).

from a purpose to compete vigorously. Courts should condemn a firm with such a purpose.

The structure of s. 36 prevents courts condemning conduct on purpose alone. But, as in the U.S. purpose plays an important role in distinguishing predation and normal competition. However, one must always remember that purpose alone does not suffice. In many cases the purpose of predation and the purpose of competition are the same, viz., to increase sales and thus harm rivals.

To breach s. 36 a dominant firm must have the purpose of achieving one or more of the consequences described in s.36(1)(a)-(c). It is unnecessary that the dominant firm achieve the consequences. On the other hand, liability does not automatically occur if the dominant firm's conduct leads to the s.36(1)(a)-(c) consequences. The key question is whether the dominant firm had the requisite purpose. Dyson Heydon has stated the test as:

"What may be required is proof that the conduct producing the consequences was motivated by or inspired by a wish for the occurrence of the consequence".¹⁷⁶

A firm may know that one of the listed consequences may occur as a result of its conduct yet still not have the requisite purpose. The High Court in Port Nelson¹⁷⁷ recognised this and observed:

"The word used is not merely "intention". Intention to do an act, which it is known will have anticompetitive consequences, in itself is not enough. "Purpose" implies object or aim. The requirement is that "the conduct producing the consequences was motivated or inspired by a wish for the occurrence of the consequences": Donald and Heydon Trade Practices Law (1989) para 5.400, p 2621; In the words of Toohey J. in Queensland Wire Industries Pty

176 D. HEYDON, TRADE PRACTICES LAW, Vol. 1., para 5.40.

177 Supra, note 89.

Ltd v Broken Hill Pty Co. Ltd (1989) 83 ALR 577, 602, speaking of the Australian s. 46(1)(a), (b) and (c):

"The reference to 'for the purpose of' carries with it the notion of an intent to achieve the result spoken of in each of the paragraphs in s. 46(1)".¹⁷⁸

Thus, the Court distinguished between purpose and intention. A dominant firm can intend to do an act knowing it will have one or more of the proscribed consequences, yet not have the requisite purposes. The Federal Court of Australia recognised this in Berlaz Pty Ltd v Fine Leather Care Products Ltd.¹⁷⁹ Fine Leather manufactured leather goods. Berlaz distributed them. A number of disputes arose between the parties. In particular, Fine Leather was concerned that Berlaz had relabelled its goods. Evidence showed Fine Leather was contemplating competing with Berlaz. Fine Leather terminated Berlaz distributorship agreement. Berlaz sought an injunction, claiming Fine Leather's purpose was to eliminate or substantially damage it as a competitor. Fine Leather claimed it terminated Berlaz because it was an unsatisfactory distributor. Pincus J. dismissed Berlaz's application. He held it was not possible to conclude Fine Leather's purpose was to suppress competition or deter competition. His Honour held:

"A distinction has to be drawn between purpose and consequence. The clear impression I have gained from the evidence is that [Fine Leather's] purpose in acting as it did was not to get rid of or damage Berlaz as a competitor, although no doubt [Fine Leather] knew that terminating the distributorship would be likely to have one or both of these results".¹⁸⁰

178 Id. at 707.

179 (1991) ATPR, para 41-118.

180 Id. at 52, 768.

Similarly in Eastern Express Pty Ltd v General Newspapers Pty Ltd¹⁸¹

the Federal Court recognised knowledge that conduct will damage rivals is not enough to establish liability.

"The mere admission by [two witnesses] of a recognition that the aggressive activity which they thought necessary for the successful defence of Westworth Courier would damage Eastern Express is not admission by them that damage was a purpose of their activity".¹⁸²

Penlington J., in Hyde v Topmilk Ltd,¹⁸³ stressed this as well. Topmilk was the only milk processor in the far north of the North Island. It held an exclusive licence from the Milk Corporation pursuant to the Milk Act to process and supply milk in the far north. Hyde sold milk to the public and delivered it to homes, pursuant to a contract with Topmilk. The Milk Act was due to expire on 1 April 1993 and the industry was to become deregulated. Disputes arose over the plaintiff making unauthorised deliveries of milk, being behind in payments, his obstreperous attitude, poor performance as a milk vendor and failure to supply information to Topmilk. Topmilk also started making home deliveries. Topmilk then terminated its contract with Hyde for the above reasons and stopped supplying milk to Hyde. It made the home deliveries Hyde used to. Hyde sought an interim injunction alleging (inter alia) breach of s. 36. Topmilk claimed it did not have the requisite purpose. It claimed its termination was a reasonable commercial response to the situation. It was protecting its business interests. It had a statutory responsibility to maintain home delivery in

181 (1991) ATPR, para 41-128.

182 Id. at 52, 896.

183 Supra, note 116.

the far north. Once it had terminated Hyde, it made the deliveries. It had to choose someone. It chose itself. Hyde claimed Topmilk had the proscribed s. 36 purpose. Penlington J. repeated the Port Nelson comments on the difference between intention and purpose.

"Secondly, an intention to do an act which is known will have anti-competitive consequences in itself will not suffice. Rather, there must be proof that the person who has a dominant position in the market was motivated in the use of his market power by a desire to bring about the anti-competitive consequences proscribed by s. 36. See Union Shipping (NZ) Ltd v Port Nelson Ltd [1990] s NZLR 662 per McGechan J and Mr R.G. Blunt at p 707".¹⁸⁴

His Honour held Topmilk did not have the requisite purpose. Although it knew its termination would have anticompetitive consequences, it still did not have the requisite purpose. He held the purpose was to prevent Hyde making unauthorised home deliveries.¹⁸⁵ This was not the proscribed s. 36 purpose. Thus the plaintiff failed to raise a serious issue to be tried under s. 36.

Similarly, in Byers v Northland Dairy Products Ltd,¹⁸⁶ Blanchard J. distinguished intention from purpose. That a defendant knows its actions will have anticompetitive consequences does not mean that those consequences were its purpose. The facts were similar to the McDonald¹⁸⁷ case. The defendant terminated one of its vendors. It claimed its purpose in restructuring, was to make its operations more efficient so it could better meet the competitive market place after the milk industry became deregulated. In particular it wanted

184 Id. at 50.

185 Id. at 51-52.

186 Supra, note 116.

187 Supra, note 116.

to be able to respond to any move the Milk Corporation made into the Northland market. It claimed its old system of distribution was inefficient and the new system was efficient. It knew its actions would be to disadvantage the plaintiff. Blanchard J. held the defendant's reasons for restructuring and terminating the plaintiff made commercial and competitive sense. He said "... I am far from convinced that this is a change introduced in order to prejudice [the plaintiff] in any way".¹⁸⁸ Accordingly he held the defendant did not breach s. 36 as it lacked the requisite anticompetitive purpose.

Van Roy and November argue that intention and purpose are synonymous.¹⁸⁹ They argue that Courts have distinguished between direct intention and oblique intention. A direct intention is doing an action with the aim of deterring or eliminating a rival; whereas an oblique intention is doing an act knowing deterring or eliminating a rival is a side consequence. Purpose in s. 36 is direct intention. Oblique intention does not breach s. 36.¹⁹⁰ With respect, this is an exercise in semantics. The Courts have distinguished purpose and intention.¹⁹¹ Section 36 uses the word purpose - not direct intention. While purpose and direct intention may be synonymous, purpose and oblique intention are not. One cannot equate purpose with intention when purpose does

188 Byers, supra, note 116, at 30.

189 Van Roy, supra, note 145 at para 36.08; November, The Meaning of Use of a Dominant Position in a Market for a Proscribed Purpose : The Jurisprudence of Section 36(1) of the Commerce Act 1986, Unpublished LLM research paper VUWLR, 22 (1992).

190 Van Roy, id.; November, id. at 24-25.

191 See text accompanying notes 176-188, infra.

not involve oblique intention. To do so complicates analysis.

The Courts have also distinguished motive from purpose. The Port Nelson Court held once a plaintiff has established the defendant has the requisite anticompetitive purpose, the defendant's motives are irrelevant. The Court noted:

"If, however, the anticompetitive effects are within the defendant's purpose, questions of morality and motive become irrelevant: "there is no breach of s. 46 unless there has been a use of market power for one of the purposes proscribed by the section. But once it appears there has been use of market power for such a purpose, the section has been contravened and it adds nothing to consider the motives of the corporation taking advantage of the market power which it has": Queensland Wire Industries at p 601, per Toohey J. To like effect we note Deane J. at p 587: It is "not to the point" the anticompetitive purpose "is inspired by altruistic or even patriotic motives eg ... to protect local standards and employment".¹⁹²

Cooke P. made the same distinction in Apple & Pear Board v Apple Fields Ltd.¹⁹³ At issue was whether a levy the Board imposed on new growers had the purpose of deterring entry into the apple growing industry. The High Court held the Board's purpose was to increase fairness between new and established growers.¹⁹⁴ Cooke P. recognised this was the Board's motive but that did not mean its purpose was not anticompetitive.

"The difficulty, as I see it, is that those two ways of analysing the Board's purpose are not really different. They are not in contrast but alternative ways of saying the same thing. The Board has set out to ensure that newcomers would not be attracted to the industry partly by the prospect of establishment costs seen by the Board as unrealistically low. ... I cannot avoid the conclusion that

192 Supra, note 89, at 708.

193 [1989] 3 NZLR 158.

194 (1989) 2 NZBLC 103, 564.

the arrangement for the levy between the Board and the Fédération, however well motivated, has had a substantial purpose of deterring entry into the apple growing industry or increases of production".¹⁹⁵

Cooke P. re-emphasised this when discussing Apple Fields in Swann v Secureland Mortgage Investment Nominees Ltd.¹⁹⁶ His Honour said:

"... The policy of the board of levying contributions to capital costs inevitably involved restricting competition. The one purpose necessarily meant the other. The underlying motive was to achieve fairness, but a policy with a restrictive purpose was followed with that motive".¹⁹⁷

Another outstanding issue is whether s. 36 means objective or subjective purpose. Barker J. in ARA v Mutual Rental Cars (Auckland Airport) Ltd¹⁹⁸ favoured an objective test. His Honour relied on Smither J.'s comments in Dandy Power Equipment Pty Ltd v Mercury Marine Pty Ltd.¹⁹⁹

"Smithers J. in that case referred to the equivalent provision in the Australian Act as needing to be interpreted objectively; he relied on tax cases in which the subjective purpose, motive or intention of a taxpayer was held irrelevant in interpreting tax evasion legislation which was concerned with the character of acts done and transactions".²⁰⁰

Holland J. in the High Court in Apple Fields favoured a subjective test.²⁰¹ Cooke P. in the Court of Appeal left the question open. Tipping J. in Magic

195 Supra, note 193, at 162.

196 [1992] 2 NZLR 145.

197 Id. at 147.

198 [1987] 2 NZLR 647.

199 (1986) 69 ALR 660.

200 Supra, note 198, at 664.

201 Supra, note 194, at 103, 581.

Millions held s. 36 involved a subjective test.

"When one is talking of purpose one is really talking about what a party has in mind. It is clearly a subjective matter. Unless that party gives evidence ... as to its purpose then the court is left to infer with what purpose a person acts from all the available and relevant materials".²⁰²

His Honour quoted no authorities. The Port Nelson Court disagreed:

"We must say we are reluctant to adopt an entirely subjective approach. As the development of the law of contract rather demonstrates, the commercial field is one in which objective ascertainment of states of mind has much to commend it. We would be sorry to see the objectives of s. 36 inhibited by any undue subjectivity as to purpose, perhaps more natural to the criminal law. However, in the light of Tipping J.'s firmly expressed view, we will leave the question of principle open".²⁰³

Subsequent Courts have favoured the objective approach. The High Court in

Clear v Telecom²⁰⁴ observed:

"... when one is considering the overall purpose or intent of a large corporation an objective assessment should be made".²⁰⁵

The Court of Appeal in the same case observed:²⁰⁶

"In circumstances such as prevail in this case - where a competitor realistically cannot enter the market without access to the facilities of a firm in a dominant position, a separate investigation of the purpose of the behaviour is hardly necessary. The anti-competitive purpose is to be inferred from the inevitability of the consequences of refusing to deal except on terms that lead to competitive disadvantage."²⁰⁷

202 Supra, note 1, at 731.

203 Supra, note 89, at 709.

204 (1992) 5 TCLR 166.

205 Id. at 198.

206 Supra, note 114, at 38.

207 Id. at 39.

This is an objective test.

The High Court of Australia in QWI²⁰⁸ did not specifically deal with the issue. However, it inferred that BHP had an anticompetitive purpose for the following reasons:

1. BHP did not offer a legitimate business reason for refusing to sell to QWI.²⁰⁹
2. Y-bar was the only product of BHP's rolling mills it did not offer to sell.²¹⁰
3. BHP knew that the major distributors insisted on a full range of rural fencing products consisting of posts and wire. By refusing to supply Y-bar BHP could keep the major distributors for itself.²¹¹
4. BHP had acted in such a way that was not possible in a competitive market. It had excess capacity in its steel rolling mills. In a competitive market it would have supplied, rather than lose sales.²¹²

This seems to indicate an objective test. The High Court did not rely on any "smoking gun" such as an internal note. It inferred purpose.

However, subsequent Courts including the Full Federal Court in ASX Operations v Pont Data Pty Ltd²¹³ and the Federal Court in Eastern Express

208 Supra, note 12.

209 Id. at 50, 011.

210 Id. at 50, 011, 50, 012 and 50, 025.

211 Id. at 50, 011.

212 Id. at 50, 011, 50, 016 - 50, 017 and 50, 025.

213 (1991) ATPR, para 41 - 069.

Pty Ltd v General Newspapers Pty Ltd²¹⁴ and Dowling v Dalgety Australia Ltd²¹⁵ held s. 46 involved subjective purpose.

The Full Federal Court in General Newspapers Pty Ltd v Telstra Corp.²¹⁶ reached the opposite conclusion, holding s. 46 involves objective purpose. Davies and Einfield J.J. after analysing OWI held:

"... after it has been ascertained what the nature of the conduct was, what the conduct was designed and what it was likely to achieve and what was the manner of its implementation. The ultimate test is an objective test which ... involves notions of markets, market power, competitions in a market and competition".²¹⁷

The weight of authority both in Australia and New Zealand, thus, favours an objective test.

Van Roy and November argue, however, it should be a subjective test.²¹⁸ Van Roy argues the Port Nelson analogy with the purpose of a contract is incorrect. She argues that a contract cannot have a purpose - only people can. Thus, when courts construe a contract, they are determining its meaning, not the purpose behind it. Thus, courts should adopt subjective purpose.²¹⁹ However, Van Roy's major premise that contracts do not have a purpose is misplaced. The Australian and New Zealand Courts interpret

214 (1991) ATPR, para 41 - 128.

215 (1992) ATPR, para 41 - 274.

216 (1993) ATPR, para 41 - 274.

217 Id. at 41, 697.

218 Van Roy, *supra*, note 189; November, *supra*, note 189, at 31.

219 Van Roy, *id.*

contracts as having purposes in the context of tax legislation.²²⁰ A contract may have the purpose of tax evasion. In those cases the subjective purpose of the taxpayer who entered the contract is irrelevant. The same concept must apply to s. 36.

In many cases, however the distinction between subjective and objective purpose will be irrelevant. Cooke P. in Tui Foods Ltd v N.Z. Milk Corporation Ltd²²¹ suggested there was no difference. Although that case involved s. 29 His Honour's comments apply to s. 36:

"In argument reference has been made to some difference of opinion in the High Court as to whether the test of purpose under s. 29 is objective or subjective or a mixture of the two. Cases discussing that kind of question include New Zealand Magic Millions Ltd v Wrightson Bloodstock Ltd [1990] 1 N.Z.L.R. 731, Union Shipping NZ Ltd v Port Nelson Ltd [1990] 2 N.Z.L.R. 662, and Auckland Regional Authority v Mutual Rental Cars (Auckland Airport) Ltd [1987] 2 N.Z.L.R. 647. I am disposed to think that, if a purpose is discernible on the face of a contract or arrangement having regard to the express terms considered in the light of any relevant surrounding circumstances, such a purpose will qualify under the statute. That might be described as an objective approach. But it is at least conceivable that there may also be cases where, although the purpose is not so apparent, it can be shown by evidence dehors a contract or arrangement that the intention of the party who sought the inclusion of the relevant provision was of a kind falling within the prohibition in s. 29, and it may be that in such a case what may be called a subjective test is sufficient. It is unnecessary however for present purposes to express a definite view on that point because, on the face of this particular rebate arrangement and the evidence, it is manifestly well arguable in my view that there is no difference between an objective test and a subjective test: that both are satisfied".²²²

Similarly in Port Nelson the High Court both objective and subjective

220 See, supra, note 200.

221 Unreported, 2/11/93, CA 243/93.

222 Id. at 5-6.

standards were met. The Court observed:

"Proof of purpose, in the nature of these cases often will turn upon inferences drawn from actions and circumstances, with a sprinkling of internal memoranda and correspondence. Protestations of inner thoughts which do not reconcile with objective likelihoods are unlikely to carry much weight. In many cases, and this ultimately is one, both objective and subjective standards are met."²²³

The High Court in Clear v Telecom quoted this approvingly and noted in that case the distinction between objective and subjective purpose was "academic".²²⁴

Proof of Purpose:

Courts, as seen above, infer purpose from the dominant firm's conduct. They also can rely on written documents and memoranda by the dominant firm. However, the latter should not be determinative. They may simply be mere bragging or statements consistent with hard competition. For example in Olympia Equipment Leasing Co. v Western Union Telegraph Co.²²⁵ the defendant had made notes saying such things "as these turkeys ought to be flushed".²²⁶ Judge Posner held such statements were consistent with hard normal competitive behaviour. Indeed the High Court in Clear v Telecom implies that one should regard such statements with caution.²²⁷

223 Supra, note 89, at 707.

224 Supra, note 204, at 57.

225 Supra, note 169.

226 Id. at 376.

227 Supra, note 204, at 198.

The Second Circuit Court of Appeals best summed up what courts should do when faced with such statements in William Inglis and Sons Baking Co. v ITT Continental Baking Co.²²⁸ The Court noted that mere "boardroom ruminations" regarding rivals are not sufficient evidence of predatory intent. What is required instead are direct implications that can be drawn from available evidence on the underlying purposes of the defendant's actions. It further noted that mere "bragging" or other gratuitous statements are hardly sufficient to determine the intent behind specific conduct.²²⁹ The Full Federal Court in Eastern Express Pty Ltd v General Newspapers Pty Ltd²³⁰ held similarly. This involved alleged predatory pricing. The defendant had (inter alia) made press statements saying it was going to defeat the newcomer. The Full Federal Court held: "bellicose imagery employed in [press] interviews [was] more indicative of swagger, braggadocio and the presentation of a 'strong' image to readers ..., [than] of the existence of a purpose proscribed by s. 46".²³¹

Another important element in proving purpose is whether the defendant can show it had a legitimate business justification for its conduct. If the defendant can show it had legitimate commercial justifications for its conduct courts will be unlikely to find it had an anticompetitive purpose. Conversely, if it cannot courts will likely infer an anticompetitive purpose.

QWI is a good example. BHP could not offer a legitimate business

228 688 F. 2d 1014 (9th Cir. 1981), cert. denied, 459 U.S. 825 (1982).

229 Id. at 1035.

230 (1992) ATPR, para 41-167.

231 Id.

reason for its refusal to supply. Mason C.J. and Wilson J. said:

"Thus conclusion [of Pincus J.] that the effective refusal to sell was for an impermissible purpose was supported by the fact that BHP did not offer a legitimate reason for the effective refusal to sell ..."²³²

Subsequent Australian Courts have found no anticompetitive purpose where the defendant offered a legitimate business reason for its conduct. In Dowling²³³ the defendants said their reason not to allow the plaintiff the use of their stockyards was not to share it with persons who had no proprietary interest in it and to use it as they saw fit. Lockhart J. while accepting that a subsidiary purpose was not allowing competition said that the defendant's dominant and substantial purpose was the former and thus the plaintiffs had not established purpose.²³⁴

Taprobane v Singapore Airlines Ltd v Taprobane Tours W.A. Pty. Ltd²³⁵ involved Singapore Airlines terminating Taprobane's services as a travel agent. Singapore Airlines claimed its purpose was to improve its profitability by ensuring it dealt only with established operators who might be expected to provide regular and reliable custom to it. Singapore Airlines had lost money when one of its previous agents had collapsed. The Federal Court held Singapore Airlines had the requisite proscribed purpose as the evidence showed Taprobane was an efficient operator which did not represent any risk of financial

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233 *Supra*, note 215.

234 *Id.* at 40, 276. His Honour's comments were obiter.

235 (1992) ATPR, para 41-159, (Full Federal Court); (1990) ATPR, para 41-054. (Federal Court).

loss to Singapore Airlines. The Full Federal Court reversed. The case turned on market definition. The Court observed (obiter) that although there was evidence of a degree of less than rational antagonism to Taprobane by Singapore Airlines, that did not support the inference of an anticompetitive purpose. The airline's conduct did not appear to have had any anticompetitive objective. The airline's purpose in terminating Taprobane was its stated one.²³⁶

In Berlaz Pty Ltd v Fine Leather Care Products Ltd,²³⁷ Pincus J. held Fine Leather's purpose was its stated one of terminating an unsatisfactory distributor. That it also had the consequence of decreasing competition did not mean Fine Leather had that purpose. In Natwest Australia Bank Limited v Boral Gerrad Strapping Systems Pty Ltd,²³⁸ Boral refused to supply its exclusive product because the plaintiff was insolvent and owed it a debt. French J. held this was not a taking advantage but also held Boral did not have the requisite anticompetitive purpose. His Honour held Boral's purpose was to make certain it received payment from an insolvent creditor.²³⁹ This is not anticompetitive.

Australian Performing Right Association Ltd v Ceridale Pty Ltd²⁴⁰ involved a dispute as to the amount of past licence fees. APRA owned performing rights which it licensed to performers. APRA refused to licence the

236 Id. at 40, 178.

237 (1991) ATPR, para 41-118.

238 (1992) ATPR, para 41-196.

239 Id. at 40, 644.

240 (1990) ATPR, para 41-042 (Federal Court); (1991) ATPR, para 41-074.

defendants until they had paid in full. The trial judge inferred, despite the dispute, that APRA's purpose was to prevent the defendants from engaging in competitive conduct in the provision of a night club.²⁴¹ On appeal the Full Federal Court reversed this inference and finding a purpose. The Court held:

"APRA had nothing to gain by putting the respondents out of business. On the contrary, it was in the interests of APRA to maximise the number of its material, so long as they paid licence fees. APRA's purpose was merely to prevent unauthorised use of its material, so long as they paid licence fees. APRA's purpose was merely to prevent unauthorised use of its material and the integrity of its licensing system".²⁴²

Pre-OWI cases held the same. In Top Performance Motors Pty Ltd v Ira Berk (Old) Pty Ltd²⁴³ Joske J. held that

"the respondent had substantial reasons for terminating its agreement with the applicant and I am satisfied on the evidence that the respondent genuinely considered that it should terminate the agreement for the sake of and in order to protect its legitimate trade and business interests".²⁴⁴

The above authority shows that if a defendant shows it had a legitimate business justification for its conduct Australian Courts are unlikely to find that the defendant had the requisite anticompetitive purpose.

New Zealand courts have indicated the same. ARA²⁴⁵ involved the ARA limiting the number of rental vehicle concessions at Auckland Airport to

241 Id. at 51, 582.

242 Supra, note 240, at 52, 129.

243 (1975) ATPR, para 40-004:

244 Ibid.

245 [1987] 2 NZLR 647.

two firms. An excluded firm, Budget, claimed the ARA had breached s. 36 by refusing it a concession. Its purpose was to exclude other potential licensees thereby reducing competition. Barker J. held the ARA had breached s. 36 but left open the possibility of a legitimate business justification defence. (By defence I mean if the dominant firm raises a legitimate business justification the Court will not find anticompetitive purpose). Barker J. said:

"I emphasise that ARA does not necessarily have to accept any applicant for a rental car concession, including Budget. The availability of space, level of service proposed for the public and other considerations will operate as reasonable constraints ...".²⁴⁶

The High Court in Port Nelson²⁴⁷ said:

"The activity covered will not be prohibited despite foreseen anticompetitive effects if it arises for unrelated legitimate business reasons without purposive pursuit of those anticompetitive outcomes in themselves".²⁴⁸

New Zealand Milk Corp. v McDonald²⁴⁹ is also relevant. The New Zealand Milk Corporation terminated a group of milk vendors' contracts to supply milk. The parties entered into these contracts pursuant to s. 9(5) of the Milk Act 1988. Under this the Corporation could contract out home deliveries on an exclusive zone basis. The vendors sought an injunction alleging breach of s. 36. They succeeded in the High Court and Court of Appeal. The Court ultimately granted the injunction on the basis the Corporation had abused its statutory powers under s. 9(5) of the Milk Act. Hardie Boys J. however thought

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247 Supra, note 89.

248 Id. at 708.

249 Supra, note 116.

the Corporation did not have the requisite anticompetitive purpose. He acknowledged the Board's conduct had an anticompetitive effect but said:

"But effect does not necessarily establish purpose ... The purpose here was to secure a competitive advantage, which unless coupled with a purpose of the kind referred to in s. 36 is a legitimate objective of free competition. The borderline is a fine one. Here, I incline to the view that the fate of the unlucky vendors was no more than an effect on an incident of a legitimate purpose. In my opinion the unlawfulness of the purpose lies in s. 9(5) of the Milk Act, not in s. 36 of the Commerce Act".²⁵⁰

The High Court in Clear v Telecom also emphasised the OWI test that even a monopolist may refuse to supply for a legitimate reason.²⁵¹

Thus, it is arguable a legitimate business reasons defence is part of New Zealand law.

A number of comments can be made about the concept.

U.S. law recognises such a defence. Aspen Skiing Co. v Aspen Highlands Skiing Corp.²⁵² involved a dominant ski operator refusing to continue a joint marketing arrangement with a smaller competitor. The trial judge had instructed the jury that a firm's refusal to deal with a rival does not breach s. 2 of the Sherman Act so long as "valid business reasons exist for that refusal". The jury found a breach and the Court of Appeals and Supreme Court affirmed. The Supreme Court considered whether the trial record supported the jury's conclusion there was no valid business reasons for the defendants refusal to deal. The linchpin of the inquiry was whether the evidence showed that the defendant

250. Id. at 552.

251. Supra, note 204, at 195.

252. 472 U.S. 585 (1985).

had been attempting to exclude rivals on some basis other than efficiency. The defendant did not offer any. The Court found none. It held that:

"the evidence supports an inference that [the defendant] was not motivated by efficiency concerns and that it was willing to sacrifice short-run benefits and consumer goodwill in exchange for a perceived long-run impact on its smaller rival".²⁵³

The Court held the jury's conclusion was "strongly supported by [the defendant's] failure to offer any efficiency justification whatever for its pattern of behaviour".²⁵⁴

The Supreme Court thus, placed efficiency at the heart of the legitimate business defence. If the reasons the defendant proffers for its conduct do not enhance efficiency they will not be legitimate business reasons.

Subsequent U.S. courts, following Aspen recognise the legitimate business reasons defence. In Trace X Chemical Inc. v Canadian Industries Ltd²⁵⁵ the Eight Circuit Court of Appeals dealing with the defendant's refusal to extend credit or replace defective material, discussed the difference between acceptable and illegal conduct by a monopolist:

"Anticompetitive conduct is conduct without legitimate business purpose. Such conduct makes sense only because it eliminates competition. Acts which are ordinary business practices typical of those used in a competitive market do not constitute anticompetitive conduct violative of Section 2. The exercise of business judgment cannot be found to be anticompetitive".²⁵⁶

Second, the defence is a legitimate business purposes defence. Courts will

253 Id. at 206.

254 Ibid.

255 738 F. 2d 261 (8th Cir. 1984), cert. denied, 469 U.S. 1160 (1985).

256 Id. at 266.

not simply accept a dominant firm's preferred reason. They will assess it. One has to be careful before accepting a dominant firm's reasons for its conduct. This is especially so in New Zealand where the Government has privatised state monopolies. Doctor James Farmer has noted:

"... the former state monopolies, while possessing first-come advantages given to them by earlier statutory regimes that conferred their monopoly status on them were also inevitably saddled with the legacy of historically high-cost structures and inefficient management and labour systems and practices. These made them extremely vulnerable to new entrants, especially those enjoying the benefit of foreign capital and expertise and able to make use of modern low-cost, technology and implement efficient systems without incurring heavy transition and restructuring costs".²⁵⁷

Thus, a dominant firm may claim its purpose is to achieve efficiency. However, its real purpose may be to prevent the newcomer taking advantage of its greater efficiencies and new technology, thus impairing competition.

An example of this is Port Nelson.²⁵⁸ The port company claimed the purpose of its levy was to enable its staff and equipment to be fully utilised. However, the Court found that the levy was too high to achieve that. It could have done so by having a lower levy. The high levy indicated that its purpose was to eliminate the use of non Port Nelson equipment and staff. Thus, courts will not automatically accept any business justification a defendant gives. The justification must be legitimate. This is true in the U.S. as well.

Thirdly, some commentators have argued the defence is not open under the Commerce Act. Thomas Weston and Bernard Hill argue Cooke P's

257 Farmer, Transition from Protected Monopoly to Competition : The New Zealand Experiment, 1 CCLJ, 1, 7 (1993).

258 *Supra*, note 89.

comments in Apple Fields ran counter to a legitimate business defense.²⁵⁹

Cooke P. observed:

"The difficulty, as I see it, is that those two ways of analysing the Board's purpose are not really different. They are not in contrast but alternative ways of saving the same thing. The Board has set out to ensure that newcomers would not be attracted to the industry partly by the prospect of establishment costs seen by the Board as unrealistically low. ... I cannot avoid the conclusion that the arrangement for the levy between the Board and the Federation, however well motivated, has had a substantial purpose of deterring entry into the apple growing industry or increases of production".²⁶⁰

Weston and Hill's argument depends on Apple Field's motive in imposing the levy being a legitimate one. With respect, it was not. It was a blatant Raising Rivals' Costs scenario. It hobbled new growers. It made them incur a cost with no justification other than fairness. Fairness has nothing to do with efficiency. It simply made life more difficult for the new competitors. It made apples more expensive for domestic consumers. It was based on the concept of a levy playing field to which the High Court in Fisher & Paykel v Commerce Commission²⁶¹ gave a short shift. Apple Fields is not authority for rejecting a legitimate business purpose defence as the purpose was not legitimate.

Cooke P.'s comments in N.Z. Milk Corp.²⁶² seem to run counter to a legitimate business purpose defence. His Honour accepted that "the line between effective competition and impermissible use of a dominant position can

259 Hill & Weston, Monopolisation and Telecommunications Markets in New Zealand, Unpublished Seminar Paper, 25 (1993).

260 [19890 3 NZLR 158 at 162.

261 [1990] 2 NZLR 731.

262 Supra, note 116.

be a fine one"²⁶³ but concluded:

"... I am unable to accept that a statutory monopolist who seeks to exclude traders from a market can say plausibly that this is only an attempt to compete more effectively with possible future competitors. Inevitably the ouster is much more than that. The purpose is necessarily restrictive of competition".²⁶⁴

On the other hand, Hardie Boys J. held the defendant did not have an anticompetitive purpose. As mentioned above, he said the Board's purpose was to secure a competitive advantage.²⁶⁵ This was not anticompetitive. Blanchard J. held similarly in the Byers²⁶⁶ case. His Honour framed the purpose in efficiency terms.

[The Defendant's] case is that the old system was based on cost plus and was very inefficient. It therefore had to be restructured for the reasons set out in the portions of the affidavits, especially that of Mr Sowter, quoted above. Daily allowances had to be got rid of and remuneration systems standardized. The reallocation of milk rounds was also part of a new marketing exercise involving the adoption of new brand names, the launching of new products and the use of new "get up".²⁶⁷

Seeking to become more efficient is a legitimate business purpose.

The milk cases show how different courts can have views on purpose. All involved substantially the same facts - yet the Courts reached different conclusions on purpose. Penlington J., Blanchard J., Thorp J. and Hardie Boys J. held the defendants did not have an anticompetitive purpose. Cooke P.,

263 Id. at 546.

264 Ibid.

265 Id. at 552.

266 Supra, note 116.

267 Id. at 24.

Hilyer J. and Neazor J. thought the defendants did. Of course, ultimately it is a matter of fact.

Section 2(5)(b) of the Commerce Act may negate a legitimate business purpose defence. This provides that a proscribed purpose need only be a substantial purpose. It need not be the sole or even dominant purpose. A dominant firm may have a legitimate purpose, but its substantial purpose may be an anticompetitive purpose. Whether it is, is a question of fact. Australia has an equivalent provision; viz. s. 4F(b). However, as I showed above, most courts now will not infer an anticompetitive purpose if the defendant shows a legitimate business purpose despite s. 4F(b). Not all Australian cases do this as Mark Lyons Pty Ltd v Bursill Sportsgear Pty Ltd²⁶⁸ (a pre OWI decision) shows. Mark Lyons was a ski gear retailer. It organised warehouse sales of discounted gear at temporary locations. Bursill was the sole Australian distributor of Salomon ski equipment. Practically speaking a retailer had to stock Salomon to meet customer demand. Retail rivals of Mark Lyons periodically complained to Bursill about Mark Lyons' discounting. Bursill refused to supply Mark Lyons with Salomon boots after the 1987 season. Mark Lyons alleged (inter alia) a breach of s. 46. Bursill contended its purpose was to prevent conduct which could bring the product into disrepute. It claimed its purpose was to protect its products' image. Wilcox J. held Bursill breached s. 46. He stated that under s. 4F(b):

"it is sufficient that an applicant prove that one of the purposes actuating a respondent - provided only that this one purpose was substantial - was the deterrence or prevention of competition. It

268 (1987) ATPR, para 40-818.

is not necessary to prove that this was the sole purpose".²⁶⁹

His Honour further held:

"I think that it is clear that one of the purposes which actuated Mr Bursill's decision to refuse to supply of in-line ski boots to Mark Lyons for the 1987 season was the desire to protect his established retailers from the competition presented to them by Mark Lyons' sales. Some people may regard that as a laudable motive but such a purpose clearly offends against s. 46(1)(c). The withholding of the boots is for the purpose of deterring or preventing Mark Lyons from engaging in competitive conduct - that is, the warehouse sales - in the Australian ski boot market".²⁷⁰

It was possible to infer the anticompetitive purpose here. One of Bursill's purposes was to prevent Mark Lyons discounting. Bursill had received complaints from other retailers over Mark Lyons discounting. While Bursill had the purpose of protecting its image, it also had the purpose of preventing discounting. Preventing discounting harms consumer welfare. If a specified price is involved it is per se illegal under the Resale Price Maintenance provisions.²⁷¹ This, under s. 4F(b), was a substantial purpose. Thus, Bursill breached s. 46. Had Mark Lyons not been discounting and only conducting sales from warehouses, it is unlikely the Court would have inferred an anticompetitive purpose. Stopping sales from warehouses does not harm consumer welfare. All the other Australian cases where courts have accepted a legitimate business purpose did not involve the plaintiff discounting.

Whether a purpose is substantial is a matter of fact. Section 2(5)(b) certainly does not defeat the legitimate business purpose defence. One cannot

269 Id. at 48, 800.

270 Id. at 48, 802.

271 Sections 37-42 Commerce Act; sections 96-100 Trade Practices Act.

argue it does in the case of mixed purposes. To do so would in effect be saying that purpose equated with known consequences. The Courts have rejected this.

Fourth, the Court of Appeal's decision in Clear v Telecom²⁷² may have eliminated a legitimate business purpose defence. As mentioned above, the case concerned the price Telecom charged Clear for interconnection; viz. the Baumol-Willig rule. The Court of Appeal held the rule because it captured Telecom's monopoly profits breached s. 36. As for purpose, the Court of Appeal held:

"In circumstances such as prevail in this case - where a competitor realistically cannot enter the market without access to the facilities of a firm in a dominant position, a separate investigation of the purpose of the behaviour is hardly necessary. The anti-competitive purpose is to be inferred from the inevitability of the consequences of refusing to deal except on terms that lead to competitive disadvantage.- As Mr Fogarty emphasised, it is necessary to bear in mind s. 2(5)(b) which provides that so long as it is a substantial purpose it is sufficient if it is included in the purposes of the conduct".²⁷³

This is undoubtedly correct in this case. Telecom claimed its purpose was not anticompetitive. Rather it was to increase efficiency. I shall argue later that any rule which ensures monopoly profits is inimical to efficiency. Efficiency was at issue in this case. Just because Telecom claimed its purpose was efficiency did not mean the Court had to accept it. Just as in Port Nelson the Court held the means Telecom used to achieve efficiency were unduly restrictive. Thus, it could infer an anticompetitive purpose from that. However, the Court of Appeal's comments are with respect too wide. The dominant firm may have any number of reasons why it refuses to deal. The new entrant may be a credit risk or a

272 Supra, note 114.

273 Id. at 39.

debtor of the dominant firm as in Boral.²⁷⁴ It is hardly an anticompetitive purpose to refuse supply until the entrant has cleared the debt or shown its financial stability. The new entrant may prevent a safety risk. This was so when the British Monopolies Commission investigated the LPG industry. A number of LPG suppliers refused to supply distributors because they had inadequate storage and handling facilities for LPG cylinders.²⁷⁵ A refusal to supply for such safety reasons would not be an anticompetitive purpose, irrespective of its effect on the competitive ability of the spurned distributors. A New Zealand example is Merivale Service Station (1984) Ltd v Mobil Oil (NZ) Ltd.²⁷⁶ Mobil stopped supplying the service station with petrol because of evidence the station's underground tanks were leaking. The station sought an injunction, claiming Mobil by ceasing supply had breached (inter alia) s. 36. Fraser J. denied the injunction. He said he was not prepared to infer an anticompetitive purpose. Mobil's purpose in ceasing supply was that there was a real risk of further leakage and environmental harm if it resumed supply. His Honour held this, despite the inevitable consequence was to competitively disadvantage the service station.

Similarly, albeit in different circumstances, U.S. courts have allowed moral justifications for refusals to deal. A monopolist may refuse to sell advertising

274. Supra, note 46.

275. See, Chard, Economic Effects of Exclusive Purchasing Arrangements in the Distribution of Goods, in MARKETING CHANNELS 39, 40-41 (L. Pellegrini & S. Reddy eds. 1986).

276. Unreported, 15/7/93, Christchurch, CP 2/8/93, Fraser J.

space to X-rated film exhibitors,²⁷⁷ or firms which engage in deceptive advertising or other breaches of ethical codes or unfair practices.²⁷⁸ One can hardly call these purposes anticompetitive despite the inevitable anticompetitive consequences on the firms that require access to the monopolist's facilities.

The Court of Appeal could be correct if all the above instances were dealt with under s. 36's use limb. A refusal to deal because of safety reasons, moral reasons or the firm seeking access being a debtor or poor credit risk is conduct which a nondominant firm could perform. Thus, a court in such cases would find no use and thus no breach of s. 36. It would not have to consider purpose. Indeed, the Courts could have decided the milk cases under the "use" limbs as well. McDonald,²⁷⁹ Byers²⁸⁰ and Capital Dairy²⁸¹ involved the defendants restructuring its operations to become more efficient and competitive. This is possible, indeed mandatory, for a firm in a competitive market. The Courts could have said that because of this, none of the firms had used their dominant positions. The only issue would be whether their restructuring was unnecessarily restrictive. This would avoid the courts having to pour over numerous documents to try and find some incriminating statement. Even if they did, the statements would not be determinative, as they would be consistent with

277 America's Best Cinema Corp. v Fort Wayne New Papers, Inc., 347 F. Supp. 328 (1972).

278 Homefinders of America, Inc. v Providence Journal Co., 621 F. 2d 441 (1st Cir. 1980).

279 *Supra*, note 116.

280 *Id.*

281 *Id.*

hard competition as well as predation. However, the Court of Appeal in Clear v Telecom appeared not to treat use in that way. The judgment seems to imply it would deal with the above examples under the purpose limb. The Court noted:

To determine whether particular conduct involves use of a dominant position in a market for any of the purposes specified in s. 36 has been said to require consideration of whether the conduct would have been open if the party concerned were not in a dominant position - if it were in a fully competitive market. Such a test reflects the underlying purpose of the section which is to promote competition. Even monopolists are entitled to act competitively and the section must not be applied so as to constrain them. It is the purpose of the conduct which distinguishes what is proscribed from what is legitimate.²⁸²

The above discussions show how interconnected the use and purpose limbs of s. 36 are. However, Clear v Telecom does not appear to foreclose a legitimate business purpose defence. It was just in the circumstances of the case that the court could infer the anticompetitive conduct. Telecom could hardly claim its conduct was efficiency enhancing when its conduct was totally counter to efficiency.

The plaintiff in any s. 36 case still has the burden of proof. A defendant will have the evidential burden of showing a legitimate business purpose. The plaintiff will have to prove it was not or that the defendant's substantial purpose was anticompetitive.

The Proscribed Purposes:

Paragraph s. 36(1)(a) - This deals with restricting entry. This captures

282 Supra, note 114, at 24 (emphasis added).

conduct aimed at potential entrants.

Paragraph (b) preventing or deterring - This is an extremely wide reach covering actual and potential rivals. The word deterring suggests making life more difficult. It means s. 36 is wider than the U.S. standard under s. 2 of the Sherman Act. The cases talk of exclusion and foreclosure. These are wider concepts than deterring.

Paragraph (c) deals with elimination of current competitor or any trader from any market. This is more in line with the U.S. authorities.

The references to that or any other market means the defendant need not use its dominant position in the market in which it is dominant. Section 36 does not limit where the dominant firm must use its dominant position. Similarly the dominant firm need not compete in the same market as the alleged victim. This means the controversy over leverage in the U.S. does not arise in New Zealand.²⁸³

Harm to Competition or Competitors?

Another issue with s. 36 is whether it is concerned with harm to competition or individual competitors. The issue arises because s. 36's purpose provisions are directed against individual competitors. As Hampton notes:

"A literal reading of the [purpose provisions] suggests that a dominant firm will breach the section when it uses its position with the intention of harming some "person" : the section does not appear to require proof of an intention to harm competitors".²⁸⁴

283 ABA ANTITRUST SECTION, ANTITRUST LAW DEVELOPMENTS 250-252 (3d ed. 1992).

284 Hampton, *supra*, note 3, at 213.

Courts could use this to interpret s. 36 in such a way so that whenever a dominant firm prevails over a rival, it breaches s. 36. This will be so whether or not the dominant firm's triumph is due to it simply being a more efficient competitor.

However the Courts have shown they will not do this. Tipping J. in Magic Millions held:

"It is not a breach of s. 36 if a person albeit with a dominant position, simply acts in a competitive manner. It would be an irony if such conduct could be attacked because it is competition which the Act is designed to promote".²⁸⁵

If a person acts in a competitive manner it will harm a less efficient rival. This, however, will not breach s. 36. Tipping J's comments indicate that Courts will use the Act's long title to interpret s. 36. The long title states it is "an Act to promote competition in markets within New Zealand". If a dominant firm's actions do not harm competition it will not breach s. 36. Courts' comments show they do not view competition as a large number of rivals, i.e. a state resembling perfect competition.

The Port Nelson Court held:

"Such provisions [Sections 27 and 36 Commerce Act 1986] are directed at the protection of the concept of competition as such. They are not directed at the protection of individual competitors, except in so far as the latter may promote the former".²⁸⁶

Similarly Barker J. stated in the ARA case:

"The test of competition is not concerned with the economic fate of individual competitors".

285 Supra, note 2.

286 Supra, note 89, at 700.

Australian courts have held similarly. The High Court of Australia in QWI²⁸⁷, in rejecting Pincus J's holding that "take advantage" incorporates an intent element, stress s. 46's object is the protection of the interest of consumers through promoting competition.

"[T]here is a fundamental difference between the usual tort and a s. 46 violation. In the ordinary tort case, a tortfeasor's intent may well be relevant to his dangerousness - if he intends to hurt another he is more likely to cause injury than if he is not trying to hurt the other. If the purpose of s. 46 were the economic well-being of competitors, then a similar implication of intent might well be appropriate: see Olympia Equipment Leasing v Western Union Telegraph.

But the object of s. 46 is to protect the interests of consumers, the operation of the section being predicated on the assumption that competition is a means to that end. Competition by its very nature is deliberate and ruthless. Competitors jockey for sales, the more effective competitors injuring the less effective by taking sales away. Competitors always try to 'injure' each other in this way. The competition has never been a tort (see Keebel v Hickeringill) and these injuries are the inevitable consequence of the competition s. 46 is designed to foster. In fact, the purpose provisions in s. 46(1) are cast in such a way as to prohibit conduct designed to threaten that competition".²⁸⁸

Deane J. expressed similar views:

"[T]he essential notions which s. 46 is concerned and the objective which the section is designed to achieve are economic and not moral ones The objective is the protection and advancement of a competitive environment and competitive conduct by precluding advantage being taken of a 'substantial degree of power in a market for any of the proscribed purposes'".²⁸⁹

By stressing that s. 46 aims to protect consumers through competition the High Court is stressing efficiency over preserving numerous rivals. As shown in

287 Supra, note 12.

288 Supra, note 12, at 50, 101, per Mason C.J. and Wilson J. (emphasis added).

289 Id. at 50, 011.

Chapter I allowing inefficient small firms to survive decreases consumer welfare by decreasing allocative efficiency.

Subsequent Australian courts have followed the QWI comments.

Lockhart J., in Dowling, said:

"Competition by its very nature is deliberate and ruthless and s. 46 encourages this. What it discourages is conduct which would not be possible in a competitive market, thereby promoting competitive conduct".²⁹⁰

Thus, s. 36 does not protect inefficient small firms. What it does is condemn dominant firm predation. Predation, like normal competition harms rivals. The way courts interpret s. 36 distinguishes predation from normal competition. While harm to rivals will always be a factor, it will not be the determinative factor. The use and purpose limbs ensure courts will not condemn efficient normal competitive behaviour. The way courts have interpreted use and purpose ensures this.

Dynamic efficiency proponents may challenge this. They will argue dynamic efficiency depends on numerous competitors - so courts should interpret s. 36 so as to condemn harm to rivals. However, as I mentioned in Chapter I dynamic efficiency depends on the unprovable assumption that the most innovation occurs in markets with numerous rivals. Indeed some commentators argue the opposite innovation occurs the most in tightly concentrated markets with large firms who can afford large scale research and development.²⁹¹ Courts should not interpret s. 36 on the basis of an unprovable and controversial

290. *Supra*, note 41, at 40, 281.

291. Jorde & Teece, Innovation, Cooperation and Antitrust 4 HIGH TECH L.J. 1 (1989).

assumption. To do so would harm consumers, as it will lead to a decrease in productive efficiency and higher prices. It would also be interpreting on the basis of hope. Hope, that one of the small inefficient firms will make some startlingly new innovation. Antitrust cannot be based on hope. However, dynamic efficiency can play a role in s. 36. If a small rival has superior technology than the dominant firm, courts should be extremely sceptical of any dominant firm behaviour which excludes, prevents or deters the small firm from competing. Courts should be able to infer an anticompetitive purpose very easily in such circumstances. They should view any efficiency justification which the dominant firm proffers extremely carefully. For example, in Clear v Telecom, if Clear had superior technology than Telecom, the High Court should have regarded any efficiency justification sceptically. However, the reports do not show whether Clear had superior technology which made it more efficient. This is the only situation where dynamic efficiency should play a role in s. 36.

The RRC Model and s. 36:

The model is compatible with s. 36. If a dominant firm is able to raise its rivals' costs to such an extent that it can price supracompetitively or prevent prices falling a court will be able to infer the requisite purpose. It should ignore any dominant firms claimed efficiency justification. The issue will be whether a firm has used its dominant position to raise rivals' costs. In most cases it will be, as the methods which raise rivals' costs substantially and significantly will only be possible and rational for firms that are not in fully competitive markets. The model is based on consumer welfare and I have argued the Courts have had

consumer welfare underpinning their interpretation of s. 36.

Krattenmaker and Salop are undecided whether the model permits an efficiency defence. Courts cannot authorise a breach of s. 36 on efficiency (or any other grounds).²⁹² The problem with allowing an efficiency defence is that it is impossible to measure efficiencies. Posner refers to efficiencies as "an intractable subject for litigation".²⁹³ Bork has rejected an efficiencies defence.²⁹⁴ They make these comments in relation to mergers. If an efficiencies defence is too problematic there, it is too problematic for s. 36.²⁹⁵ Thus, the model and s. 36 are compatible. To assess the model's usefulness to s. 36 I now will deal with various types of conduct which courts have held breaches s. 36.

292 Section 36(3).

293 POSNER, *ANTITRUST LAW : AN ECONOMIC ANALYSIS*, 112 (1976).

294 BORK, *supra*, note 62, at 124-129.

295 Weiss has suggested that efficiencies are quantifiable. However, this analysis is too complex for courts to use, Weiss, Using the Efficiencies Defence in Horizontal Mergers, 37 *ANTITRUST BULL.*, 123 (1992).

CHAPTER VI

PRICE SQUEEZES

Introduction:

Price squeezes by a vertically integrated monopolist have been one of antitrust's concerns.¹ A vertically integrated firm performs two or more stages in the production and distribution of an end product. For example, a firm may produce raw materials or components and also manufacture the final product out of those materials or components. Similarly, a firm may manufacture the end product, but also be involved in distributing it to retailers or selling it to consumers directly.

To effect a price squeeze the vertically integrated monopolist must have a monopoly at one stage in the production or distribution stage. The stage where the firm has the monopoly must be necessary for the firm and its unintegrated rivals to compete in another market. For example, the firm may have a monopoly in the raw material necessary to manufacture an end product. The firm will compete with rivals in the market for the end product. The firm can institute a price squeeze by charging an unreasonably high price to rivals for the raw material. This will cause the price for the rivals' end product to rise to such an extent, that it may be impossible for rivals to compete in the end

1 See generally, D. Swanson, *Essays in the Economic Analysis of the Antitrust Laws*, 1-64 (1986) (unpublished Ph.D. dissertation, Harvard University).

product market. An example is the Queensland Wire Industries Pty, Ltd. v Broken Hill Proprietary Co. Ltd case.² BHP was the sole Australian manufacturer of Y-bar stock feed. Y-bar is necessary to produce steel picket fences. BHP only sold Y-bar to Australian Wire Industries (AWI) - one of its wholly-owned subsidiaries. QWI bought steel picket fences from BHP and competed with it in the Queensland rural fencing market. QWI wanted to manufacture its own steel picket fences. It asked BHP to supply it with Y-bar to enable it to do so. BHP refused to supply, except at unrealistically high prices. These high prices constituted the price squeeze. Pincus J. in the Federal Court and the High Court did not refer to BHP's high price for Y-bar as a price squeeze. They called it a "constructive refusal to supply".³ However, they are synonymous. The High Court held BHP's constructive refusal to supply or price squeeze breached s. 46 of the Trade Practices Act. Other Courts around the world have held price squeezes can breach the antitrust laws. No court yet has analysed price squeezes using the RRC model. In part II I will outline the U.S. law on price squeezes and apply the RRC model to one case. In part III I will analyse three Australian cases, QWI, O'Keefe Nominees Pty Ltd v BP Australia⁴ and ASX Operations Pty, Ltd v Pont Data Australia Pty, Ltd⁵ using the RRC model. In part IV I will analyse two New Zealand cases, Union Shipping N.Z.

2 (1989) ATPR, para 40-925.

3 Id. at 50, 011.

4 (1990) ATPR, para 41-057.

5 (1990) ATPR, para 41-007 and on appeal (1991) ATPR, para 41-109.

Ltd v Port Nelson Ltd⁶ and Clear Communications Ltd v Telecom Corporation of N.Z. Ltd,⁷ using the RRC model. Part VI will conclude the model is relevant and useful in assessing price squeezes under s. 36 of the Commerce Act.

U.S. Law:

The first U.S. case relevant to price squeezes was U.S. v Colgate & Co.⁸ Colgate was a manufacturer. It announced a suggested resale price and refused to supply distributors who sold below that price. The trial judge dismissed the complaint. The Supreme Court upheld his decision. The Court held that firms have a general freedom to deal or not to deal as they choose. However, this freedom is qualified. McReynolds J. stated:

"In the absence of any purpose to create or maintain a monopoly the [Sherman] Act does not restrict the long-recognised right of trader or manufacturer engaged in an entirely private business, freely to exercise his own independent discretion as to parties with whom he will deal. And, of course, he may announce in advance the circumstances under which he will refuse to sell".⁹

One of the qualifications, viz; refusal where the firm has "the purpose to create or maintain a monopoly" covers a price squeeze. The firm may be partially integrated. It may have a monopoly over an input to the final product. For example, raw materials or a component. By charging a high price for the input the firm would be constructively refusing to supply. One could construe

6 [1990] 2 NZLR 662.

7 Unreported 17/12/93 CA 25/93.

8 250 U.S. 300 (1919).

9 Id. at 307.

this as having "the purpose to create or maintain a monopoly" over the final product. However, the issue was not before the Court and further elucidation was not possible until U.S. v Aluminium Co. of America (Alcoa).¹⁰ The U.S. Justice Department alleged (inter alia) that Alcoa had engaged in a price squeeze. Alcoa had a monopoly over aluminium ingot. It converted some of it into finished products such as rolled aluminium sheets and aluminium cable. It sold this to industrial buyers. It also sold some of the aluminium ingot to other firms (aluminium fabricators) which converted it into finished products. Alcoa and the fabricators thus competed in the finished aluminium product market. The fabricators were not vertically integrated. The Justice Department alleged Alcoa set the price of ingot so high and the price of its finished products so low that the unintegrated fabricators could not compete in the market for finished aluminium products.

Judge Learned Hand agreed. He held Alcoa had breached s. 2. He set out the constituent elements for an illegal price squeeze. A firm would breach s. 2 where -

- (1) it has monopoly power over one product,
- (2) its price for that product is higher than a "fair price",
- (3) that product is necessary to compete in a second market where the firm itself competes,
- (4) its price in the second market is so low that rivals cannot match it and still earn a "living profit".

The Court noted Alcoa's cost of converting its ingot into finished products

10 148 F. 2d 416 (2d Cir. 1945).

as a fair measure of the cost its rivals faced in converting ingot into finished products. It concluded that in most cases, the cost of ingot plus the cost of converting to rivals was greater than Alcoa's finished product price. This prevented Alcoa's rivals from profitably competing in the finished product market. It held once Alcoa knew how its pricing policy was affecting its rivals in the finished product market, Alcoa had breached s. 2 by unlawfully using its monopoly power in ingot to set the price of its ingot unfairly high and the price of its finished product prohibitively low.¹¹ Ironically, Judge Hand held the price squeeze did not contribute to him finding Alcoa guilty of unlawfully maintaining a monopoly in ingot.¹² The Court also expressly noted that the squeeze was not part of an attempt to monopolise the finished product market. The unlawful conduct was Alcoa setting the price of ingot higher than a "fair price" and setting the price of its finished product so low as to preclude "a living profit" for rivals who bought ingot from Alcoa.

Commentators from all sides of the antitrust spectrum have severely criticised the decision. Professors Phillip Areeda and Donald Turner state the decision "was wrong".¹³ Professor Stephen Ross says the same.¹⁴ They, with respect, are correct. If the squeeze did not maintain Alcoa's power in the ingot market or help extend its power into the finished product market, then it simply

11 Id. at 436-438.

12 Id. at 438.

13 III P. AREEDA & D. TURNER, ANTITRUST LAW, 236 (1978). See also R. BORK, THE ANTITRUST PARADOX : A POLICY AT WAR WITH ITSELF, 243 (2d ed. 1993).

14 S. ROSS, PRINCIPLES OF ANTITRUST LAW, 81 (1993).

reflected Alcoa's exercise of monopoly power. It is not an antitrust breach to exercise monopoly power by charging monopoly prices.¹⁵ (Alcoa was presumably charging monopoly prices for its ingot.)

Commentators have also criticised the decision for laying down uncertain guidelines.¹⁶ What is a "fair price" for aluminium ingot? How does a court determine it? It could be a reasonable return on the capital Alcoa invested in securing its monopoly in ingot. However, this may not be the competitive price. In times of high demand, it would be below the competitive price. In times of low demand, it would be above the competitive price. If the competitive price for ingot is above the "fair price", how does the Court set the fair price? Judge Hand suggested determining the fair price should involve Alcoa's price in converting the ingot, plus a "living profit" for rivals in the finished product market.¹⁷ This raises the question of what a living profit is. Is it a normal return on investment in converting ingot to finished products? Simply relying on Alcoa's costs of converting may not lead to a living profit for rivals. Alcoa may be much more efficient in converting ingot than its rivals. Thus, if Alcoa

15 This is true in the U.S. See Berkey Photo, Inc. v Eastman Kodak Co., 603 F. 2d 263, 274 n. 12 (2d Cir. 1979), cert. denied, 444 U.S. 1093 (1980); Continental Cablevision v American Electric Power Co., 715 F. 2d 1115, 1121 (6th Cir. 1983); P. AREEDA & H. HOVENKAMP, ANTITRUST LAW, 756 (Supp. 1990). It is a breach of Article 86 of the Treaty of Rome. See Fox, Monopolisation and Dominance in the United States and the European Community : Efficiency, Opportunity and Fairness, 61 NOTRE DAME L. REV., 981, 990-994 (1986); Adams, European and American Antitrust Regulation of Pricing by Monopolists, 18 VAND. J. TRANSNATIONAL LAW, 1, 3 (1985).

16 AREEDA & TURNER, *supra*, note 13, at 237-239.

17 *Supra*, note 10, at 438.

charged its rivals the same price it cost itself to obtain the ingot, its rivals would not be able to make a profit. If so, whose costs are relevant? Marginal rivals, the average rival or some hypothetical rival? Ensuring rivals could obtain a profit, regardless of how efficient they are, will lead the courts to preserving inefficient rivals in the market. This, as shown in Chapter I will not benefit consumers at all. They will have to suffer higher prices. Some extreme dynamic efficiency proponents may favour this, in the hope that one of the inefficient rivals develops a more efficient way of converting ingot. However, this is speculative. The new method of conversion may never eventuate. In the meantime, consumers will face higher prices. Allowing inefficient firms to survive in the hope of a future innovation is a poor trade-off for present efficiency gains.

Alcoa's price squeeze may not have been the result of its deliberate efforts. The price for ingot may have risen because of a shortage. This will squeeze its rival producers of finished products - irrespective of whether their demand changes or not. Similarly, Alcoa's low finished product price may have been the result of demand for finished products decreasing. It may have been, as mentioned above, because Alcoa was more efficient in converting ingot. Given the problems in ascertaining a fair price, the only real remedy in such circumstances would be to divest Alcoa of either its ingot monopoly, or its end product business. This would help its rivals, but would harm consumers, as they would not reap the benefits of Alcoa's efficiency. An alternative would be price regulation.

Despite its problems, Alcoa remains a precedent. Plaintiffs can and still

bring price squeeze cases. However, very few have involved the Alcoa situation, where a defendant had a monopoly in an input used to create a second product. Only one such case has found a breach of s. 2; via, Bonjorno v Kaiser Aluminium & Chem. Co.¹⁸ Kaiser manufactured aluminium sheet and aluminium culverts. It used the sheet to manufacture culverts. It sold some sheet to independent culvert manufacturers - including Bonjorno. It also sold culvert to users. It had 80 per cent of the aluminium culvert market. Kaiser sold sheet at two prices : a "specification price" for general purposes and a lower "commodity price" for culvert manufacturers. Bonjorno started buying sheet from Kaiser's competitors, so Kaiser stopped selling Bonjorno sheet at the commodity price. This meant Bonjorno had to pay as much for the sheet as Kaiser charged for culvert. Bonjorno could not compete with Kaiser in the culvert market. Kaiser testified it withdrew the commodity price because it no longer wished to sell to Bonjorno. Bonjorno alleged this was an illegal price squeeze. The jury agreed and the Third Circuit Court of Appeals upheld. Although Kaiser was not a monopolist in aluminium sheet (its rivals produced more), there was some evidence it was a price leader. Although saying it was "problematic",¹⁹ the Court held the price leadership in sheet was sufficient for the jury to find an illegal price squeeze in the culvert market. The Court also held that a price squeeze was only illegal when the defendant intended to engage in a price squeeze.

"The plaintiff must present evidence that the defendants

18 752 F. 2d 802 (3d Cir. 1984), cert. denied, 477 U.S. 908 (1986).

19 Id. at 809.

deliberately produced the effect, sufficient to provide a reasonable basis for the jury to conclude that the 'squeeze' was not the result of natural market forces such as supply and demand or legitimate competition".²⁰

This removes one of the criticisms of Alcoa, i.e. the squeeze may be the result of natural competition or market conditions. The Alcoa decision did not provide a means of excluding such events from an illegal price squeeze. The Court concluded:

"When a monopolist competes by denying a source of supply to his competitors, raises his competitors' prices for raw materials without affecting his own costs, ... then his actions have crossed the shadowy barrier of the Sherman Act".²¹

Most price squeeze cases have involved the same product at two different levels of the distribution chain. Electric power at the wholesale and retail levels has been the most common scenario.²² City of Mishawaka, Indiana v American Electric Power, Inc.²³ is illustrative. American Electric was a privately owned utility which sold electric power at the wholesale level to local distribution systems that sold power at retail to consumers. It also sold power to consumers. It charged the City of Mishawaka's distribution system a wholesale price which

20 Id. at 809-810.

21 Id. at 811.

22 See Borough of Lansdale v Philadelphia Electric Co., 692 F. 2d 307 (3rd Cir. 1982); City of Kirkwood v Union Electrical Co., 671 F. 2d 1173 (8th Cir. 1982), cert. denied, 459 U.S. 1170 (1983); City of Grotor v Connecticut Power & Light Co., 662 F. 2d 921 (2d Cir. 1981); Borough of Ellwood City v Pennsylvania Power Co., 462 F. Supp. 1343 (W.D. Pa. 1979); Metro Mobile CTS, Inc. v New Vector Communications, 892 F. 2d 62 (9th Cir. 1989) (this involved an alleged price squeeze between retail and wholesale cellular telephone services).

23 465 F. Supp. 1320 (N.D. Ind. 1979), aff'd in part, vacated in part, 616 F. 2d 976 (7th Cir. 1980), cert. denied, 449 U.S. 1096 (1981).

exceeded its retail price. As the City had no viable alternative source of supply, this eliminated the City as a competitor in the retail market. Both the trial court and the Seventh Circuit Court of Appeals held this was an illegal price squeeze. The Court also held a specific intent to maintain a monopoly, not the general intent usually required under s. 2, was necessary for a price squeeze.²⁴ The Court also set down a test for a fair price. This was the comparative billing test.²⁵ This measures the price the wholesale customer pays against the price the monopolist charges its retail customers. If the wholesale price is greater than the retail price, then the wholesale price is too high and the Court presumes an illegal price squeeze. A defendant can rebut the presumption by showing the squeeze was due to changes in demand, i.e. normal competition.

Other courts have established different tests for a fair price. The Seventh Circuit Court of Appeals in Ray v Indiana & Michigan Electric Co.,²⁶ following Alcoa, established the transfer price test. Here, "the Court asks whether the vertically integrated company could have made a profit by selling at its own retail rates if it had purchased at its own wholesale rates. If it could have made a profit under these assumptions, there was no price squeeze".²⁷ This takes account of the efficiency objection to the Alcoa test. If the vertically integrated company could make a profit at its own wholesale rates and its rivals could not,

24 616 F. 2d at 985.

25 Id. 809; Bonjorno, supra, note 18, adopted a similar test.

26 606 F. Supp. 757 (N.D. Ind. 1984) (citing Alcoa 148 F. 2d at 436; Illinois Cities of Bethany v F.E.R.C., 670 F. 2d 187, 194-99 (D.C. Cir. 1981)), aff'd 758 F. 2d 1148 (7th Cir. 1985).

27 Id. at 776.

the vertically integrated company must be more efficient than its rivals. If so, it will not breach s. 2.

A third test is the comparative rate of return test. The D.C. Circuit Court of Appeals established this in City of Batavia v F.E.R.C.²⁸ This involves a cost-based analysis of the challenged rates:

"If after the wholesale and retail costs are fully allocated, the vertically integrated company's wholesale profit margin was significantly greater than its retail profit margin, an illegal price squeeze probably occurred".²⁹

The First Circuit Court of Appeals, in Town of Concord v Boston Edison Co.,³⁰ has eliminated the possibility of a plaintiff bringing a price squeeze claim, where the defendant's rates are regulated. Edison was an integrated power company that generated, transmitted and distributed power in Massachusetts. It also sold some of its power to rivals and used its lines to transmit electricity its rivals purchased from other generators. The Federal Energy Regulation Commission (F.E.R.C.) regulated the rates Edison charged for selling wholesale power or for transmitting power. Another body regulated the rates it charged for distributing power to consumers. Concord, ran a distribution system that bought wholesale from Edison. Edison, over three years, persuaded the F.E.R.C. to authorise increases in the wholesale rates it charged customers like Concord. It did not seek an increase in its own retail rates. Concord claimed Edison was engaging in a price squeeze. The wholesale price was going up, while Edison

28 672 F. 2d 64 (D.C. Cir. 1982).

29 Id. at 90.

30 915 F. 2d 17 (1st Cir. 1990), cert. denied, 111 S. Ct. 1373 (1991).

kept a low retail price. Concord's retail price was becoming non-competitive with Edison. Thus, it was losing customers to Edison and not gaining new ones.

Judge Stephen Breyer held the regulation of Edison's rates in both the wholesale and retail markets barred a finding of antitrust liability.³¹ He held regulation reduced the likelihood that a monopolist would be able to charge an unreasonably high price in the first market. Regulation in the second market suggested it was probably a natural monopoly with little prospect of competition, in any event. Regulators could prohibit Edison's extension of its power into the retail market, if they chose. He also noted Concord, which had a legal monopoly in retail distribution within its municipal limits, was unlikely to go into bankruptcy given its stable customer base, even if it was disadvantaged in respect of customers who could choose their plant locations. He distinguished cases such as City of Mishawaka,³² on the basis they involved several allegations of exclusionary conduct - including a price squeeze. Concord just involved a price squeeze. The other cases also involved wholesale prices which exceeded retail prices. Concord did not.

Judge Breyer also commented on price squeezes in unregulated industries.³³ He conceded that price squeezes could allow a monopolist to extend its power into a second market, by raising entry barriers, by forcing new firms to compete with the monopolist in two markets rather than one and depriving the market of nonprice competition and pressures for innovation.

31 Id. at 28.

32 Supra, note 23.

33 Id. at 29-31.

However, he severely doubted this would occur often. He also gave three reasons why courts should be cautious in condemning a price squeeze. First, the monopolist might be more efficient and innovative than its rivals. Second, consumers will benefit if the victim of the price squeeze is a monopolist. Third, a court cannot determine whether a set of wholesale and retail prices constitute a price squeeze without engaging in rate-setting price regulation.³⁴

Although Judge Breyer's comments on price squeezes in unregulated industries were obiter, they have been influential. In the U.S., now, it is extremely difficult to establish a price squeeze.

A number of reasons exist for U.S. Courts scepticism towards price squeezes. The first is over monopoly pricing. A vertically integrated firm which is allegedly price squeezing will normally have a monopoly over the input. To effect a price squeeze it will charge a monopoly price for its input. Monopoly pricing does not breach the Sherman Act.³⁵ To breach s. 2 a firm must improperly gain or retain monopoly power. Simply exercising monopoly power where such exercise does not affect the firm's ability to maintain power does not breach s. 2.³⁶ U.S. Courts place monopoly pricing in this category. Monopoly pricing does not entrench the monopolist's position. It does the opposite. It attracts new entrants, eager to share in the profits. The new entrants will force the prices down. A monopolist may be able to price that way because it innovated and became the most efficient firm. Monopoly profits are the reward

34 Id. at 30-31.

35 See, *supra*, note 15.

36 See, ROSS, *supra*, note 14, at 28.

for its innovation. Thus, courts will not attack them. As monopoly pricing does not incur antitrust liability, neither does high pricing, which may not be monopoly pricing. An example of this is Laurel Sand & Travel, Inc. v CSX Transportation Inc.³⁷ The plaintiff alleged CSX had denied it access to its rail tracks by offering to transport the plaintiff's goods, while denying trackage rights to the plaintiff over CSX's tracks. The plaintiff considered CSX's price for transporting its goods as too high. It alleged the price was too high to allow it to compete successfully with CSX. In essence, it alleged a price squeeze. The Fourth Circuit Court of Appeals considered whether CSX's price was reasonable. The price was "\$2.12 per ton, a penny over CSX's average variable costs".³⁸ The Court held the price was reasonable. It held it must view reasonableness from CSX's perspective in the rail business, regardless of whether the rate allowed the plaintiff to be competitive in its business. It added:

"[T]he reasonable standard of the access factor cannot be read to mean the assurance of a profit for the person seeking access".³⁹

Thus, the Court removed Alcoa's standard of "a living profit" from price squeeze litigation. CSX's price of just above average variable costs is not monopoly charging. It was not helping it to maintain a monopoly. The U.S. approach to monopoly and high pricing contrasts with Article 86 of the Treaty of Rome. This defines "abuse of a dominant position" to include "imposing

37 1991-1 Trade Cases (CCH), para 69, 312 at 65, 185 (1991).

38 Id. at 65, 190.

39 Ibid.

unfair purchase on selling prices".⁴⁰ As Professor Gregory Adams notes:

"[Unfair pricing] does not resemble the kind of conduct that fits the principal United States test for monopolization : the wilful acquisition or maintenance of monopoly power. [Unfair pricing] in contrast represents the type of conduct by which monopoly power is exploited".⁴¹

A second reason for U.S. scepticism with price squeezes is that it involves leveraging. The price squeezing firm with the monopoly input is attempting to leverage its power into the end product market. Leveraging occurs when a monopolist has a competitive advantage at the second-level market because of its control at the first level, rather than because it is more efficient at the second level.

Commentators have severely criticised the leveraging doctrine. Robert

40 In full it reads:

"Any abuse by one or more undertakings of a dominant position within the common market or in a substantial part of it shall be prohibited as incompatible with the common market in so far as it may affect trade between Member States. Such abuse may, in particular, consist in:

- (a) directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions;
- (b) limiting production, markets or technical development to the prejudice of consumers;
- (c) applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;
- (d) making the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts."

41 Adams, *supra*, note 15, at 3.

Bork,⁴² Judge Richard Posner and Judge Frank Easterbrook⁴³ argue there is only one monopoly profit to be made in the chain of distribution. Leveraging involves "double counting", i.e. courts count the same degree of market power twice. A monopolist cannot increase its profits by extending or leveraging that monopoly into a vertically adjacent market.

A controversy exists in the U.S. over whether leveraging is a breach of s. 2. The Supreme Court in U.S. v Griffith⁴⁴ held it does. It held a firm cannot use monopoly power "to beget monopoly".⁴⁵ It held the defendant's use of its monopoly of theatres in some cities to obtain exclusive film distribution privileges in cities where its theatres faced competition constituted illegal monopolisation. However, the controversy is over whether a monopolist breaches s. 2 when it uses its monopoly power to achieve an advantage in a second market, without threatening to monopolise that market. In Berkey Photo, Inc. v Eastman Kodak Co.⁴⁶ the Second Circuit stated that:

"[A] firm violates s. 2 by using its monopoly power in one market to gain a competitive advantage in another, albeit without an attempt to monopolise the second market".⁴⁷

Other Circuits, including the Sixth Circuit in Kerasotes Michigan Theatres v

42 R. BORK, THE ANTITRUST PARADOX : A POLICY AT WAR WITH ITSELF, 141-144 (2d ed. 1993).

43 R. POSNER & F. EASTERBROOK, ANTITRUST CASES AND MATERIALS, 870 (2d ed. 1981).

44 334 U.S. 100 (1948).

45 *Id.* at 108.

46 *Supra*, note 15.

47 *Id.* at 275.

National Amusements Inc.⁴⁸ have followed Berkey. The Ninth Circuit in Alaska Airlines v U.S.⁴⁹ explicitly rejected the Berkey findings. The Court noted that the antitrust laws tolerate natural monopolies and those that arise from efficiency and stated:

"Thus, the elements of the established actions for monopolisation and attempted monopolisation are vital to differentiate between efficient and natural monopolies on the one hand, and unlawful monopolies on the other. Berkey Photo's monopoly leveraging doctrine fails to differentiate properly among monopolies. The anticompetitive dangers that implicate the Sherman Act are not present when a monopolist has a lawful monopoly in one market and uses its power to gain a competitive advantage in the second market. By definition, the monopolist has failed to gain, or attempt to gain, a monopoly in the second market. Thus such activity fails to meet the second element necessary to establish a violation of s. 2. Unless the monopolist uses its power in the first market to acquire and maintain a monopoly in the second market, or to attempt to do so, there is no s. 2 violation".⁵⁰

Other Circuits have reserved judgment on whether they would follow Berkey and hold that leveraging breaches s. 2, even when there is no threat of monopolising the second market.⁵¹

The RRC model provides the economic underpinning for price squeezes.

48 854 F. 2d 135 (6th Cir. 1988). See also Sargent-Welch Scientific Co. v Ventron Corp., 567 F. 2d 701 (7th Cir. 1977), cert. denied, U.S. 822 (1978). Neither Judge Posner nor Judge Easterbrook have heard a leveraging case yet. Given their academic writings it is unlikely the Seventh Circuit will continue to follow Berkey.

49 948 F. 2d 536 (9th Cir. 1991).

50 Id. at 548.

51 Key Enterprises v Venice Hospital, 919 F. 2d 1550 (11th Cir. 1990); Advanced Health-Care Services v Radford Community Hospital, 910 F. 2d 139 (4th Cir. 1990); Twin Labs v Weider Health & Fitness, 900 F. 2d 166 (2d Cir. 1990). The Ninth Circuit originally left the question open in Catlin v Washington Energy Co., 791 F. 2d 1343 (9th Cir. 1986). Alaska Airlines has overruled Catlin.

A price squeeze, by its very definition raises rivals' costs. However, it does not do it by any of Krattenmaker and Salop's four scenarios. The closest are the bottleneck and real foreclosure scenarios. In those however, the price squeeze occurs by the exclusionary rights purchaser buying the only or most of the input. This causes the price of the remaining unexcluded input to raise, or forces rivals to buy more expensive substitutes. The RRC model's price squeeze is an indirect one. The traditional price squeeze is a direct one. The price squeeze could give the input monopolist the power over price in the output market. Despite the price squeeze being a paradigm RRC scenario, Krattenmmaker and Salop do not apply their model to it. This is probably due to U.S. law's benign attitude to monopolists charging high prices. However, I will apply the model to Alcoa.

For the purposes of the model, the two markets are the input market of aluminium ingot and the output market is the finished aluminium product market. The first step is to determine whether Alcoa significantly and substantially raised its rivals' costs. We need to know if the rivals could purchase sufficient ingot from either, other established ingot suppliers or from potential entrants. The case does not mention this. All we know is that Alcoa had a monopoly in ingot. We do not know how secure that monopoly was or whether new firms could easily enter the market. If Alcoa did substantially and significantly raise its rivals' costs, the next issue is whether it injured competition; viz, gained power over price in the finished aluminium product market. We need to know whether sufficient competition remained in the output market to prevent Alcoa gaining power over price. We would consider firms who bought

ingot from other suppliers and manufactured finished aluminium products. Were they sufficiently numerous to restrain Alcoa? We would also have to consider finished product imports and substitute products, such as stainless steel finished products. Only then could we determine whether Alcoa harmed consumers by gaining power over price.

The great advantage of the RC model is that it overcomes the leverage objection. Alcoa by substantially and significantly raising its rivals' costs can gain market power in the finished product market. It can prevent price from falling. It can do so, even if it does not have a monopoly in the end product market. The power to prevent prices from falling harms consumer welfare. It merits antitrust liability. However, in the U.S. it is still unlikely a court would impose liability for such a price squeeze today. The notion that a monopolist can price as high as it wants would probably prevail. However, the situation is different in Australia and New Zealand.

Australia:

The U.S. Courts scepticism over price squeezes does not apply to s. 46 of the Trade Practices Act. High or monopoly prices can constitute "taking advantage" of market power. Monopoly or high prices will only be possible because of the absence of competitive conditions. Similarly, the references to that or any other market in paragraphs 46(1)(a), (b) and (c) mean the firm with a substantial degree of market power need not take advantage of its power in the market where it enjoys market power. Thus, leverage is a possible breach

of s. 46. The key Australian case is QWI.⁵² Most commentators treat it as a refusal to supply. However, BHP did offer to supply.⁵³ Its price was unrealistically high. Hence, the Court termed it a constructive refusal to supply.⁵⁴ This is just another term for a price squeeze.

BHP produced 97 per cent of Australian steel. It supplied 85 per cent of the country's steel and steel products. It also produced Y-bar feed stock. This is necessary to produce steel picket fences. BHP was the only Australian manufacturer of Y-bars. BHP did not sell Y-bar generally. It only sold it to AWI - one of its wholly-owned subsidiaries. QWI manufactured wire from rods it bought from BHP. It also bought star picket fences from BHP and competed with BHP in the Queensland rural fencing market. It had 28 percent of that market. QWI requested BHP supply it with Y-bar. It wanted to manufacture star picket fences. BHP would only supply at an excessively high price which would prevent QWI from competing with BHP. QWI sued, alleging breach of s. 46. As mentioned earlier, QWI failed in the Federal Court⁵⁵ and Full Federal Court⁵⁶ but prevailed in the High Court.⁵⁷ The High Court held BHP had taken advantage of its market power by refusing to supply QWI. It would

52 Supra, note 2.

53 Easterbrook suggested a price squeeze was possible in QWI, Easterbrook, The Inevitability of Law and Economics, 1 LEGAL EDUCATION REV., 3, 17 (1989). Kathryn McMahon does also, McMahon Refusals to Supply by Corporations with Substantial Market Power, 22 ABLR, 7, 21 (1994).

54 See, supra, note 3.

55 (1987) ATPR, para 40-810.

56 (1988) ATPR, para 40-841.

57 (1989) ATPR, para 40-925.

have supplied in a competitive situation. The Court held BHP had the requisite anticompetitive purpose for four reasons. BHP did not offer a legitimate business reason for refusing to sell to QWI. Y-bar was the only product of BHP's rolling mills it did not offer to sell. BHP knew that the major distributors insisted on a full range of rural fencing products consisting of posts and wire. By refusing to supply Y-bar, BHP could keep the major distributors for itself. BHP had acted in such a way that was not possible in a competitive market. It had excess capacity in its steel rolling mills. In a competitive market it would have supplied rather than lose sales. The High Court did not discuss what price BHP should have supplied Y-bar. Mason C.J. and Wilson J. commented BHP breached s. 46 because it would only supply Y-bar at "an excessively high price relative to other BHP products".⁵⁸ They also commented on QWI being able to obtain supply at a "reasonable price".⁵⁹ Deane J. talked of BHP supplying only at an "unrealistically high price".⁶⁰ Toohey J. held BHP breached s. 46 because it would not supply at "competitive prices".⁶¹ Pincus J. at first instance linked the definition of a constructive refusal to supply with the ability of QWI to compete in product star picket fences.

"[T]he offer made by BHP was pitched at a level which BHP knew would make it impossible of acceptance because [QWI] could not manufacture star picket from Y-bar purchased at that price and

58 Id. at 50, 006.

59 Ibid.

60 Id. at 50, 012.

61 Id. at 50, 017.

sell it competitively".⁶²

The High Court did not grant a remedy. It sent the case back to Pincus J. to make an appropriate order. Ultimately, the parties settled the case on undisclosed terms. Apparently, QWI has never purchased Y-bar from BHP. The High Court's decision has caused considerable comment. It is the only antitrust case in the world where a vendor of a product, which it used for itself, has had to supply a new customer. Professor Warren Pengilley criticises the decision as it forces courts to set "fair" prices.⁶³ He argues courts are ill-equipped to do this. Doctor Stephen Corones argues the case can be explained on a leverage basis.⁶⁴ BHP had leveraged its power in the Y-bar market to obtain a monopoly in the star picket fence market. This seems correct, although U.S. commentators would have doubts about BHP being able to do so.

However, one can explain the case on an RRC basis. BHP by refusing to supply except at excessively high prices raised QWI's costs. This meant it gained the power over price in the star picket fence market. Under the RRC analysis the input market is Y-bar and the output market is star picket fences. By asking a high price for Y-bar BHP raised QWI's costs. To assess whether it did so substantially, we have to consider whether QWI could have obtained Y-bar elsewhere. Pincus J. noted alternative suppliers existed. Firstly, potential

62 *Supra*, note 55 at 48, 817.

63 Pengilley, Competition or Judicial Regulation? A Discussion of the Problems Resulting from Queensland Wire and its Progeny Decisions, unpublished seminar paper (1991); Pengilley, Misuse of Market Power : Present Difficulties - Future Problems, 2 TPLJ, 27, 44 (1994).

64 S. CORONES, COMPETITION LAW AND POLICY IN AUSTRALIA (1990).

suppliers existed from Korea. BHP feared Korean inputs and was prepared to drop prices by 15 per cent to meet such imports. BHP documents showed that when one of its other customers threatened to buy from Korea, BHP offered discounts to it. BHP "reacted to the threat with considerable concern". Another potential supplier, Smorgon existed, BHP believed. "It is now generally recognised that Smorgon will manufacture a Y-section and supply either Y-bar or fence posts to the market".⁶⁵

Substitutes for Y-bar existed. Boral Cyclone made X-bar fence posts, although they were not popular. Given all this, QWI may have been able to obtain Y-bar elsewhere. Thus, BHP may not have been able to raise QWI's costs substantially and significantly. The High Court, however ignored the alternative sources of Y-bar and substitutes. With respect, this was wrong. If BHP had not been able to raise QWI's costs, consumer welfare would not suffer. Only QWI as an individual competitor would. The High Court stressed s. 46 is aimed not to protect competitors but consumers.⁶⁶

If BHP did raise QWI's costs, the next issue is whether it gained the power over price in the star picket fence market. To do so we have to consider the extent of competition from other manufacturers of star picket fences. The trial court indicated rivals existed. Substantial other buyers bought rural fencing equipment from BHP and QWI in quantity and competed. A New Zealand company produced star picket fences. However, these were too expensive to sell well in Australia. Although the High Court did not consider this point, BHP

65 *Supra*, note 55, at 48, 814.

66 *Supra*, note 2, at 50, 010.

probably did have power over price. It was the predominant supplier of star picket fences. It supplied the fences to rivals. It had the ability to set prices. The New Zealand fences were too expensive - so they would not restrain BHP. It is clear BHP's suggested price of Y-bar to QWI was greater than what it supplied Y-bar to its subsidiary, AWI. Thus, even if QWI was more efficient than AWI at manufacturing star picket fences from Y-bar, it would not be able to price lower than BHP. Thus, BHP by its pricing policy, had the power to prevent prices falling in the star picket fence market. Under the RRC model, BHP would be liable. The case is a classic RRC situation. BHP by constructively refusing to supply suffered short term losses. It lost revenue by not selling to QWI. However, it gained in the long term by achieving power over price in the star picket fence market.

This is strategic predation. The model fits s. 46. BHP's high price for Y-bar meets the take advantage limb. A court could infer the requisite purpose by BHP gaining power over price. BHP, by pricing excessively in the Y-bar market, had the purpose of deterring or preventing QWI engaging in competitive conduct in the star picket fence market. The deterring purpose is important in the RRC model. Raising rival's costs to the extent of gaining power over price does not prevent rivals competing. They still can. It deters rivals, in the sense of making life more difficult for them. Consumer welfare suffers as price does not fall at all or as much as it would otherwise. The RRC does not fully explain the case, but it shows how BHP's pricing was anticompetitive. It does so in consumer welfare terms.

The problem of what price BHP could charge remains. Perhaps the

American transfer price test for price squeezes⁶⁷ is the best alternative. BHP could charge QWI for Y-bar at the maximum level at which BHP could make a profit in star picket fences. This would force QWI to be just as, or more efficient as BHP. The price should not be related to the price at which QWI can make a profit. QWI may be more inefficient than BHP. Guaranteeing QWI a profit could lead to the survival of inefficient firms. To do so would harm consumer welfare.

O'Keeffe Nominees Pty Ltd v BP Australia Ltd⁶⁸ also involved a price squeeze. This is an interlocutory decision. A full hearing has not yet occurred. O'Keeffe was a wholesaler and retailer of petroleum products in Brisbane. It obtained its supplies directly from BP. O'Keeffe supplied independent petrol stations. These competed directly with BP and five other major oil companies. BP sought to increase O'Keeffe's petrol price. O'Keeffe claimed the increase would mean it would go out of business. It sought quotes elsewhere. BP however, had the lowest prices. O'Keeffe sought an interim injunction, alleging BP had breached s. 46 by increasing its price.

Spender J. granted the injunction. He held BP, by increasing prices and decreasing O'Keeffe's profits, could have had the purpose of eliminating O'Keeffe. Spender J. held BP's price which decreased O'Keeffe's profit proved this purpose.

"The major factor is the extent of the squeeze or reduction in margin ... there has been a serious reduction in competitive ability and it is the effect of the imposed price which I regard as relevant

67 Supra, note 26 and 27.

68 Supra, note 4.

on the determination of each of those crucial aspects of s. 46".⁶⁹

Spender J. also held that some of the defendant's statements also established purpose. A manager of BP had replied to O'Keeffe's suggestion that the major oil companies wanted the independents out of the market as follows:

"They don't say it as blunt as that but it is obvious that's what they want as all the evidence points to that result".⁷⁰

With respect, the decision does not fully consider the issues. Spender J. focused on the price meaning O'Keeffe could not make a profit. This does not automatically mean BP had an anticompetitive purpose. The demand for petrol could have increased as a result of a shortage. This is likely as BP's increased price was still cheaper than the other suppliers. BP's price was within the guidelines the Trade Practices Commission and Price Surveillance Authority had published. O'Keeffe may have been inefficient. The Court did not consider whether BP retail petrol stations could have made a profit if they had to purchase petrol at the same price as O'Keeffe. Spender J. concentrated on the fate of O'Keeffe - not on the effect on consumers.

The RRC model suggests BP's price increased no harm. The input market is petrol supply. The output market is the retail petrol market. BP's price increase caused O'Keeffe's costs to increase. Although other suppliers existed these were more expensive than BP. BP may have been the most efficient producer. However, I will assume the first stage of the RRC model is met. The Cartel Ring Master or Frankenstein Monster scenarios could have

69 Id. at 51, 739.

70 Ibid.

applied. The other suppliers could have formed a cartel to fix prices for petrol. There were only five other suppliers with something like 70 per cent of the petrol supply market. Such a cartel is possible under the HHI index.

The next stage is to consider whether BP could have gained power over price in the retail petrol market. The answer must be no. O'Keeffe only had five per cent of the retail petrol market. BP had slightly over 20 per cent. In the absence of a cartel between BP and the other major oil companies, BP could not have power over price. No-one alleged such a cartel. Thus, consumers would not suffer. The RRC model has the advantage here of quickly showing BP's price increase did not harm consumers and was not worthy of antitrust concern.

A third Australian case involving a price squeeze is ASX Operations Pty Ltd v Pont Data Australia Pty Ltd.⁷¹ The Australia Stock Exchange (ASX) had a monopoly in stock exchange information. It sold this information to Pont Data which on sold it to customers. ASX had a subsidiary company JECNET which also on sold the information to customers in competition with Pont Data. Pont Data claimed ASX breached s. 46 by (inter alia) charging Pont Data an excessive fee for the stock exchange information.

Wilcox J. at first instance held ASX had breached s. 46. He said:

"[A]s I have held, the fees charged by ASXO are a function of its monopolistic position and its misuse of market power".⁷²

The Full Federal Court agreed. It held:

71 Supra, note 5.

72 (1990) ATPR, para 41-007.

"Not without hesitation, we have concluded that the judgement should be read as including the finding against ASX and ASXO [a wholly owned subsidiary of ASX] that they took advantage of market power for the purpose of deterring the retail competitors of JECNET from engaging in competitive conduct, by imposition of the fee structures in the agreements".⁷³

As with O'Keeffe the Court did not consider whether the price squeeze harmed consumers. The Full Court held s. 46 does not require a "reasonable" price. Nor does it prevent monopolists charging a monopoly price.

"[S.]46 does not strike at 'monopolists' or those in a 'monopolistic position'. Nor does it look to the attainment of a commercially 'reasonable' result. It asks whether a corporation has a substantial degree of power in a market and then proscribes the taking advantage of that power for certain purposes. Therefore, there is no contravention of that provision by a corporation with a substantial degree of power in a market which it uses to obtain a particular price, provided that in doing so the corporation has not taken advantage of its power for a proscribed purpose".⁷⁴

The Full Federal Court did not discuss the "take advantage" limb. It concentrated on purpose. It talked of ASX's "statements of intention" and "mental state". Wilcox J. in the Federal Court stated:

"It is difficult to say to what extent members of [ASX] had JECNET in mind when they set the level of fees payable under the Signal 'C' agreements ... Whatever the position, the members of [ASX] were well aware, firstly that JDS was profitable whereas JECNET was not, and secondly ... that the imposition of high charges on retailers of Signal 'C' must assist JECNET to meet the competition of those retailers".

Such statements and intentions are also consistent with normal competition. Neither court considered the effect on competition. A RRC analysis would do.

73 (1991) ATPR, para 41-069 at 52, 060.

74 Supra, note 72 at 51, 124.

As ASX was the only provider of the information, its price increase raised Pont Data's costs. Pont Data could not get the information elsewhere. It is the bottleneck scenario. Whether ASX achieved power over price is more problematic. It appears not. The Full Federal Court held that competition in the retail market was "vigorous" and "efficient". It noted the number of competitors in the market was increasing. Given this it would be unlikely ASX could achieve power over price. Thus, no liability would occur under the RRC model. Given that other firms could compete and make a profit in the retail market after buying from ASX, Pont Data may have simply been an inefficient firm. Thus, the Full Federal Court appears to have been more concerned with injury to a competitor rather than with harm to consumers. Yet QWI establishes avoidance of harm to consumers is the underlying principle of s. 46.⁷⁵ The Full Federal Court held ASX's contract with Point Data did not breach s. 45(2) of the Trade Practices Act, i.e. it did not substantially lessen competition in the retail market. The reason was the number of vigorous, efficient and increasing competitors in that market. Thus, a firm can breach s. 46 even though its actions have no, or are unlikely, to have any anticompetitive effect. A literal interpretation of s. 46 and ignoring the take advantage limb makes this possible. However, this does not achieve the very purpose of s. 46; to distinguish predation from competition. Using the RRC model to assist interpretation would help. A Court could argue, that as ASX did not gain power over price as a result of its price increase it did not have an anticompetitive purpose. Its purpose was profit maximising or making itself more competitive. A firm in a

75 Supra, note 66.

competitive industry can do this - so there was no "taking advantage of market power". The RRC model would ensure courts stressed harm to consumers rather than mere harm to an individual competitor.

New Zealand:

New Zealand has not had any s. 36 cases in which the court referred to the conduct as a price squeeze. However, one can analyse Union Shipping v Port Nelson Ltd⁷⁶ and Clear v Telecom⁷⁷ as price squeezes.

Port Nelson ran the Port of Nelson. Union Shipping was a shipping company with an associated stevedoring company Union Stevedoring. Port Nelson had a monopoly over mobile equipment and drivers over the port's wharves. The government deregulated the ports in New Zealand. Port Nelson wanted to maintain full use of its fleet of forklifts and drivers. It thus imposed a wharf user levy on Union Shipping for Union Shipping to use the port. Union Shipping claimed this breached s. 36 as it prevented it using its own stevedoring plant and manpower. Port Nelson claimed that a combination of economies of scale and high transaction costs made all cargo handling activities at the port a natural monopoly. Thus, its levy was not a use of a dominant position. It claimed this natural monopoly meant that Union Shipping had to use Port Nelson's plant or make additional payments via the levy to help Port Nelson with such economies. The High Court accepted the argument in theory. It held

76 Supra, note 6.

77 Supra, note 7.

whether the levy achieved efficiencies was simply a question of fact.⁷⁸ As a matter of fact the Court held it was not. It held the level and structure of the levy was more than commercially reasonable.⁷⁹ The Court, adopting the QWI test, held Port Nelson had used its dominant position as it could not have imposed such a high levy had it faced competition. It also inferred an anticompetitive purpose on the basis of the amount of the levy.

Again, the RRC model can aid analysis by showing how Port Nelson's conduct was anticompetitive. The input market is access to the wharves. The output market is shipping and stevedoring services. At the first stage, Port Nelson raised Union Shipping's costs by imposing the levy. It is the bottleneck scenario. Union Shipping had to go to Port Nelson to gain access. It could not go elsewhere. It seems clear that the amount of the levy gave Port Nelson power over price in the stevedoring market. No other competitors existed to restrain Port Nelson. The amount of the levy appears to have been so high that even if Union Shipping was more efficient than Port Nelson it would not prevent prices falling or prevent them falling as low as they would in a competitive market. Thus, under the model Port Nelson would be liable. One could argue it would not be under U.S. law as that permits a firm to charge as high a price as it wants. However, under Aspen,⁸⁰ Port Nelson probably would. The Supreme Court adopted the Areeda-Turner test of predation of behaviour that (inter alia) decreases competitions on the merits in an unnecessarily restrictive

78 Id. at 706.

79 Id. at 710.

80 472 U.S. 585 (1985).

way.⁸¹ The principle of a levy did not breach s. 36, it was just the amount that did. The second stage of the model (i.e. does the predator have power over price) is useful. If so, it will be hard to accept that the predator's purpose was to increase efficiency as Port Nelson claimed. However, the model does not help determine what price Port Nelson should have offered to Union Shipping. Again, perhaps the best test is the maximum price that Port Nelson could afford to pay and still make a profit. This would force Union Shipping to be as efficient or more efficient than Port Nelson. If Port Nelson had the power over price in that situation it would not be the result of a cost raising strategy, but rather because it was a more efficient competitor. If so, antitrust should not intervene.

Clear v Telecom⁸² also involved a price squeeze although neither the High Court nor the Court of Appeal referred to that term. Telecom was the former monopoly telecommunications service provider. The government privatised it and deregulated the telecommunications industry. Clear is a new entrant to the market. It sought interconnection into Telecom's network to enable it to compete in the market for local calls. One of the main issues was the price Clear should pay for interconnection. Telecom, after changing its stance, offered supply on the basis of what the High Court termed the Baumol-Willig rule. Clear alleged that Telecom breached s. 36 as it knew the Baumol-Willig rule would be unacceptable to Clear and thus, amounted to a denial of interconnection, i.e. it was a constructive refusal to supply or a price squeeze.

81 Id. at 605.

82 Supra, note 7.

Telecom argued the Commerce Act's goal is to promote competition. The essence of competition is that it leads to an efficient pricing system for goods and services. Telecom thus argued its price for interconnection should reflect the price it would offer in a competitive market.

Telecom called a number of experts, including Professor William Baumol. They said firms in competitive or contestable markets use a variety of rules to determine price. These include:

1. differential pricing, with prices that vary in their ratio to marginal costs from one product to another and from one customer group to another, inversely with elasticity of demand,
2. pricing which covers marginal or average incremental cost. (Some products will require a customer to contribute towards fixed costs),
3. opportunity costing, i.e. a customer should pay the opportunity cost of the product as well as any other incremental cost entailed in supplying it,
4. in the long term firms should earn a full competitive rate of return, i.e. total revenue must cover total costs.

Telecom relied on point 3. The High Court elaborated on the principle:

"Where the firm supplies components or intermediate goods to another firm ..." and this process entails some sacrifice of profit by the supplier firm (as when it thereby gives up some capacity that it would have otherwise used itself), then the supplier firm must be permitted to price the article in question at a level sufficient to compensate it for the profit it is forced to sacrifice because of its supply to the other firm. Economists refer to the profit unavoidably entailed in an activity as the opportunity cost of that activity".⁸³

Thus, Telecom wanted to charge Clear the full price it charged a

83 5 TCLR 166 (1993).

customer, less its average incremental costs saved by Clear carrying part of the call. Telecom charges the same profit even though Clear carries part of the call. Professor Baumol termed this a "make or buy" policy. Telecom would not "buy" a service (here Clear's connection between user and telephone exchange or local loop) if it could make the service itself less expensively. Telecom could choose between these two options. It would only interconnect Clear on terms that made it indifferent as to whether it made or bought. Telecom would not sell its loop below its profit maximising price.

Clear objected to this policy as it forced it to underwrite Telecom's existing monopoly profits and inefficiencies. The High Court held it could not determine whether these existed on the evidence before it.⁸⁴ However, the High Court accepted this. Clear's pricing policy was that both Clear and Telecom should have reciprocal access to each others network, generally without an interconnection payment subject only to a payment to balance the volume of inward and outward traffic. Clear argued reciprocity was a key feature of the case.⁸⁵ Competitive telecommunication industries require reciprocal access to each others networks. It enables a provider to give access to all phone subscribers in a location - and not just its own customers. Clear argued had the market been competitive reciprocity would be a part of it. Customers would demand it. Telecom disagreed. It argued Clear was buying an essential input and it was entitled to sell that on terms which covered its opportunity costs. It

84 Id. at 212-213.

85 Hill & Weston, Monopolisation and Telecommunications Markets in New Zealand, Unpublished Seminar Paper, 29 (1993).

did not acknowledge it was buying an input from Clear, i.e. connection to its network. The High Court accepted Clear's argument and held reciprocity was a key component.

The High Court however ruled the Baumol-Willig rule did not reach s.

36. It held:

"... [t]he implementation of the rule is more likely than the alternatives to improve efficient competition in New Zealand telecommunications. In that case, Telecom cannot be said to be using its position of dominance for the purpose of preventing or deterring Clear from engaging in competitive conduct in the New Zealand telecommunications market. If the defendant's conduct is more likely than not, in light of available alternatives, to improve competition, the defendant cannot be said to be in breach of the purpose requirements of s. 36. There is an improvement in competition when there is an enhancement of an efficient competitive process".⁸⁶

The High Court added the following reasons:

1. The rule should not impede Clear from competing provided Telecom charges Clear what it would charge itself.
2. Only firms which can provide the service at lower incremental cost than Telecom can enter the market. Only those forms which can absorb Telecom's profit and still compete on price. Clear's pricing policy would allow firms with higher costs than Telecom's to enter.
3. To that extent Clear is more efficient than Telecom and can reduce prices. Telecom will be forced to reduce prices to match Clear. This will reduce Telecom's profits. This will reduce Telecom's opportunity costs meaning it will charge a lower price to Clear. This enables Clear to reduce its prices and so on. Thus, the rule will establish a competitive

86 Supra, note 83, at 217.

process.⁸⁷

Clear appealed. The Court of Appeal reversed holding the Baumol-Willig rule breached s. 36.⁸⁸ The judgement of Gault J. identified the reasons for reversal. His Honour held charging monopoly profits in the circumstances breaches s. 36.

"... while I accept that charging monopoly profits per se is not contrary to New Zealand law it does not follow that insisting upon charging them to a competitor does not constitute a barrier to entry or a restriction upon the ability of the competitor to engage in competitive conduct. (s. 36 is not confined to wholly preventing or denying competitive conduct as seems to have been assumed by Dr Kahn)".⁸⁹

He further held:

"The inclusion in any access levy of a monopoly profit component must affect the price at which Clear can enter the market and so affect the vigour of its competitive conduct. That would constitute deterring a person from engaging in competitive conduct to use the wording of s. 36".⁹⁰

He also held that it was possible to infer that Telecom's price would include monopoly profits and that it was not an efficient firm.⁹¹ He did not consider it a defence to s. 36 that the competitive process would eliminate any monopoly rents. He held: "It would be no answer at all if the access levy, because of the monopoly pricing should constitute such a barrier as to prevent

87 Id.

88 Supra, note 7.

89 Id. at 32-33.

90 Id. at 33.

91 Id. at 34-35.

Clear from entering the market".⁹² He further added:

"I am therefore driven to reject as inappropriate an access level calculated from the base of what Telecom chooses to charge for its services and by reference to opportunity cost. I cannot accept that the objects of the Commerce Act are served by a method of pricing that secures the profits of a firm in a dominant position".⁹³

While I agree with the decision I make the following points. First, the Baumol-Willig rule does not appear applicable to Telecom. Professors Baumol and Willig argue that a single incumbent firm may not have market power if it is constrained by the prospect of entry by one or more firms not currently selling in the market. They term this a contestable market. If a firm has become the only firm in the market it must have done so by being more efficient than its rivals. Its efficiency has led it to defeat its rivals. This is the key assumption to the contestable market model.⁹⁴ Telecom was not in this position. It was, as Gault J., noted a former statutory monopoly. It won its position in the sun due to the government privatising it and deregulating the industry - not because it vanquished its rivals because of superior performance. It is wrong to apply the

92 Id. at 33.

93 Id. at 36.

94 For Baumol and Willig's academic writings see W. BAUMOL, J. PANZAR & R. WILLIG, CONTESTABLE MARKETS AND THE THEORY OF INDUSTRY STRUCTURE (1982); Baumol, Contestable Markets : An Uprising in the Theory of Industry Structure, 72 AM. ECON. REV., 1 (1982); Baumol & Willig, Fixed Costs, Sunk Costs, Entry Barriers and the Sustainability of Monopoly, 96 Q.J. ECON., 405 (1981). See also Bailey, Contestability and the Design of Regulatory and Antitrust Policy, 71 AM. ECON. REV., 178 (1981). For a comprehensive critique of the theory see Shepherd, Contestability versus Competition, 74 AM. ECON. REV. 572 (1984); W. ADAMS & J. BROCK, ANTITRUST ECONOMICS ON TRIAL : A DIALOGUE ON THE NEW LAISSEZ-FAIRE, 26-30 (1993).

Baumol-Willig rule to such a firm.

Second, Gault J. also commented that he could not see how a firm in a perfectly contestable market could monopoly price:

"[B]ut it seems to me that in a perfectly contestable market if there is one supplier sacrificing profit there will be a rival or potential entrant in a position to supply without sacrificing profit. If not, there is a monopoly supplier in the market which is contrary to the hypothesis".⁹⁵

With respect, His Honour is confusing contestable markets with perfect competition. Monopoly pricing is simply pricing above marginal cost. A firm in a contestable market has got there by being more efficient, i.e. it has a lower supply curve. Its marginal costs will be less than rivals. Thus, it will be able to price above its marginal costs (i.e. monopoly price). A rival can only enter if it can reduce its supply curve below or to the same level as the firm in the contestable market. Until a rival does the firm will be able to price above its marginal cost. This will be below potential rivals supply curves and it will still be monopoly pricing. Only in perfect competition where numerous firms compete will monopoly pricing lead to a rival or potential entrant being able to enter and take over the monopoly pricing firm's customers.

Third, Gault J. also thought the essential facilities doctrine was useful in considering the doctrine.⁹⁶ With respect, it is not. As the High Court and Cooke P. noted reciprocity was an essential feature of the case. Cooke P. noted:

"It would be essential for Clear to make use of Telecom's basic network, so that Clear customers could call Telecom customers and vice versa; 'ubiquity' is acknowledged to be essential to any

95 Supra, note 7, at 28.

96 Id. at 25.

such service".⁹⁷

This is not the case with an essential facility. A firm that has an essential facility does not need any particular customer. A firm seeking access does not provide any benefit (apart from increased revenue) to the essential facility. No reciprocity exists in an essential facility situation.

Fourth, Gault J. seemed to suggest that monopoly pricing to an entrant will breach s. 36. With respect, this is too wide. Monopoly pricing may encourage entry as firms are attracted by the monopoly profits. What was wrong with the Baumol-Willig rule was that it perpetuated Telecom's monopoly profits. The High Court argued that Clear, if it was more efficient would force Telecom to chase Clear's price down. Eventually Clear would eliminate the monopoly profits. With respect, this does not follow at all. The High Court is correct in assuming that in a competitive market if a dominant firm competes with a more efficient rival it will have to cut prices - otherwise it will lose sales and revenue. If the rival is much more efficient, the previously dominant firm will reach the stage where it will not be able to cut its price any more and it will be eliminated. This could not happen to Telecom under the Baumol-Willig rule. It always has the backstop of its monopoly profits. If Clear is more efficient, Telecom as a rational profit-maximising firm would decide it is not worth chasing the price down any further. It would be more profitable to keep charging at the Baumol-Willig price. It would reach the stage where Telecom was free riding on Clear. In this way, the rule offends against the second stage of the RRC model. It gives Telecom the power over price. It can prevent the price from falling as much as

97 Id. at 1.

it would in a competitive market.

Cooke P. seemed to realise this when he commented:

"The argument for Telecom ... is that the difficulty is overcome because, if Clear is more efficient than Telecom, Clear will be able to attract business by charging its customers less : hence Telecom in its turn will have to charge its customers less, to remain competitive : hence the "opportunity cost" for which Telecom is to be compensated will fall. That could be so but is hypothetical. Telecom would have the indemnity and to some extent at least might prefer to rely on it rather than lower prices".⁹⁸

Telecom would never be eliminated from the market. Yet, this possibility has to happen with the contestable market theory. The basis of a contestable market is that the incumbent is the most efficient. However, it may not stay that way. A more efficient firm may eliminate it. The situation was not a contestable market. It is more akin to a natural monopoly. The Baumol-Willig rule should not apply to such a market.

Fifth, the model is useful in analysing the case. As argued above, the second stage is met as the Baumol-Willig rule gives Telecom the power over price. The first stage is met as the situation is Krattenmaker and Salop's bottleneck scenario.

The Court did not say what price Telecom could charge. Gault J. seemed to indicate that Telecom would have to guarantee Clear a profit.

"In circumstances such as prevail in this case - where a competition realistically cannot enter the market without access to the facilities of a firm in a dominant position, a separate investigation of the purpose of the behaviour is hardly necessary. The anti-competitive purpose is to be inferred from the inevitability of the consequences of refusing to deal on terms that

98 Id. at 6.

lead to competitive disadvantage".⁹⁹

However, His Honour does not explicitly state that Clear has to be given access on terms that guarantee it a profit. He rejected the Baumol-Willig rule in this case as it did not exclude monopoly profits. Cooke P. stated, in relation to what price Telecom could charge:

"[T]he most that can be done is to state a principle, which can only be that Telecom is entitled to a fair commercial return for granting Clear use of the network assets, without regard to the present monopoly. This means that opportunity cost should be ignored and the charge fixed on the basis of what a network owner not in competition for the custom of subscribers could reasonably charge for use of its facilities".¹⁰⁰

This is almost identical to the fair and reasonable access to an essential facility under U.S. law. Under this doctrine the essential facility firm is allowed to charge a price to compensate it for making the initial investment in the facility.¹⁰¹ Such a charge may or may not guarantee a profit.

Indeed guaranteeing a profit harms consumer welfare. It allows a price umbrella under which small inefficient firms can survive. No one wants this. Even proponents of dynamic efficiency disagree with it.¹⁰² Clear should only obtain access if it is as efficient as Telecom. That is what would happen in a competitive market. If a dominant firm charges a price at which it could not make a profit, courts should infer an anticompetitive purpose.

99 Id. at 39.

100 Id. at 7.

101 See Chapter VII.

102 Scherer, Predatory Pricing and the Sherman Act : A Comment, 89 HARV. L. REV. 869.

The RRC model aids in analysing the case. It shows how the Baumol-Willig rule would give Telecom power over price. One cannot apply the full model to the facts of the case but it gives insights.

Interestingly, the Baumol-Willig or "make or buy" rule does not breach U.S. law. Delaware & Hudson Railway Co. v Consolidated Rail Corp.¹⁰³ involved the "make or buy" rule in the rail industry. Delaware & Hudson and Conrail were both rail companies. Delaware & Hudson wanted to use Conrail's tracks to service customers in the northeastern states. Conrail did not need to use Delaware & Hudson's tracks. Delaware & Hudson did have an alternative route but it was longer. Conrail would only allow Delaware & Hudson to use its tracks on the basis of the make or buy policy. Conrail would only let Delaware & Hudson on its tracks if it received the same profit contribution on the movement as it would have received, if it had been the sole carrier. Delaware & Hudson sued alleging breach of s. 2. Conrail applied for summary judgment claiming the make or buy policy was a legitimate business purpose as it was profit maximising. The District Court granted it. The Second Circuit Court of Appeals reversed holding genuine issues of fact arose over whether the make or buy policy was a legitimate business strategy or a plan wilfully to pressure Conrail's monopoly power. It also held evidence had to be given on whether Conrail's rates constituted a constructive refusal to supply as its prices had increased 800 per cent since the start of the shipment in question under the make or buy policy.

The case proceeded to jury trial. During the first week the judge

103 902 F. 2d 174 (2d. Cir. 1990), cert. denied, 111 S. Ct. 2041 (1991).

informed counsel he could not see any antitrust violation and that the parties should settle. Rather than enduring a seven month trial the parties did. Conrail continues to price according to the make or buy policy to this very day.¹⁰⁴

Conrail is distinguishable from Telecom. There was no reciprocity involved. Delaware & Hudson did not need to use Conrail's tracks. It had an alternative route. Thus, Conrail could never eliminate Delaware & Hudson or even hinder it in an anticompetitive sense. Delaware & Hudson could make the journey - on its alternative route. The only difference is that it would take longer. Prolonging a competitor's train journeys does not violate the antitrust laws.¹⁰⁵ Interestingly no one in the case, in their briefs or written submissions even raised the possibility, that because Conrail's charge involved monopoly profits it breached s. 2.

Conclusion:

The RRC model helps analyse price squeezes. It is most helpful when more than one supplier exists as in the O'Keeffe case. It is not as helpful when there is a monopoly supplier. One has to assume that rivals' costs are raised. Whether they are raised more than they would in a competitive market is impossible to know. However, the second stage of the model is the most useful. If a firm gains power over price because of its cost raising scenario - consumer welfare is harmed. One can also infer an anticompetitive purpose if the firm

104 Conversation and letter with Bruce Wilson, Chief Legal Officer of Consolidated Rail.

105 Chesapeake & Ohio Railway v U.S., 704 F. 2d 373 (7th Cir. 1983).

gains power over price.

CHAPTER VII

REFUSALS TO SUPPLY

Introduction:

Closely linked to price squeezes are refusals to deal. Indeed, courts call many price squeezes constructive refusals to supply. Refusing to supply can be an effective raising rivals' costs strategy. A predator may compete with a rival. It may also control an input. By refusing to supply the input, the predator can raise rivals' costs. Very few courts analyse refusals to supply as a raising rivals' costs strategy. However, courts have been concerned with and condemned monopolists refusing to supply. The traditional consumer welfare justification for condemning a monopolist's refusal to supply is based on the effect it may have on consumers. If a non-monopolist refuses to supply a rival, the rival can find another firm to supply its input. It can still compete in the market for the output. The more firms that supply a particular product, the lower prices are. Such refusals to supply do not injure consumers, as a rival can replace one supplier with another. However, the RRC model shows this is not always so. Substitute suppliers may not be as efficient and cheap as the original supplier. If so, refusal to supply can raise rivals' costs and give the predator power over price and harm consumer welfare.¹

1 Fox, The Modernisation of Antitrust : A New Equilibrium, 66 CORNELL L. REV., 1 (1981); Schill, Refusals to Deal by Single-Firm Monopolists - Should We Rob Peter to Save Paul? 63 NOTRE DAME L. REV., 214 (1988).

If an input monopolist refuses to supply, a rival has limited or no ability to secure the input. If it cannot obtain the input or a substitute, the relevant market loses a competitor it otherwise could have supported. This competitor would produce more of the output. Fewer competitors mean higher prices. The RRC model shows that the refusal to supply does not need to eliminate the rival to harm consumer welfare. The refusal may raise rivals' costs and give the predator power to prevent prices falling to what they would in a competitive market. Prices still remain high and consumers suffer.

A complicating factor arises with natural monopoly. This is a market which can only support one firm. If a monopolist refuses to deal with a firm that is competition for a natural monopoly market, that refusal to deal will not eliminate a competitor which the market could otherwise support. In the competition for a natural monopoly only one firm can win. That firm will be a monopolist. In such a case, refusal to supply will not prevent consumers from reaping the benefits of competition, i.e. lower prices at any level of the market.²

Excluding the last scenario, not every input monopolist's refusal to supply will harm consumer welfare. The monopolist may also have valid reasons for its refusals. No antitrust regime requires a monopolist to supply all the time. The RRC model helps identify which refusals are anticompetitive. Part II of this chapter examines U.S. law on refusals to supply. I will also examine the essential facilities doctrine. I will apply the RRC model to some U.S. cases and show how it aids analysis. Part III examines Australian and New Zealand law on refusals to supply. Part IV offers some conclusions. Some refusals to supply

2 Schill, *supra*, note 1, at 230.

are because the predator has entered into exclusive dealing contracts with input supplies. I shall not discuss exclusive dealing here. That is the subject of another chapter.

United States Law:

The Supreme Court in U.S. v Colgate³ established the right for a firm to refuse to supply. However, the right is unqualified. A monopolist cannot refuse to supply if it has the purpose of creating or maintaining a monopoly. The Supreme Court observed:

"In the absence of any purpose to create or maintain a monopoly, the [Sherman] Act does not restrict the long-recognised right of trader or manufacturer engaged in an entirely private business, freely to exercise his own independent discretion as to parties with whom he will deal".⁴

Subsequent cases deal with whether a monopolist had the purpose to create or maintain a monopoly. Unlike other alleged acts of monopolisation which require general intent, refusals to deal require the monopolist to have a specific intent to create or maintain a monopoly.⁵ This is the same standard required to establish an attempt to monopolise.⁶

U.S. Courts have analysed monopolists' refusals to deal under two

3 250 U.S. 300 (1919).

4 *Id.* at 307.

5 Eastman Kodak Co. v Southern Photo Materials Co., 273 U.S. 359 (1927).

6 Swift & Co. v U.S. 196 U.S. 375 (1905). See generally Cooper, Attempts and Monopolisation : A Mildly Expansionary Answer to the Prophylactic Riddle of Section 2, 72 MICH. L. REV., 373 (1974); Hawk, Attempts to Monopolise - Specific Intent as Antitrust's Ghost in the Machine, 58 CORNELL L. REV. 1, 121 (1973).

interrelated tests:

1. the intent test
2. the essential facilities test.

Courts have observed the two lines of cases are "conceptually similar"⁷ and "no bright line can be drawn between them".⁸ Some courts analyse cases using both tests. The Tenth Circuit has remarked: "the dichotomy, though in part illusory is a useful analytic tool".⁹

I shall examine each test.

1. The intent test:

The first Supreme Court case to apply this test in a refusal to supply case was Eastman Kodak Co. v Southern Photo Materials Co.¹⁰ Kodak had a monopoly over the manufacture of photographic materials and supplies. Southern was a retail rival of Kodak. Kodak had been attempting to integrate into the retail distribution of photographic supplies. It had bought out most of its retail rivals. Southern refused to sell. Kodak, then refused to sell at the normal wholesale rate to Southern. Southern sued alleging breach of s. 2. The Supreme Court agreed. It read a purpose requirement into s. 2. It held monopolists have narrower dealing prerogatives than ordinary firms.

7 Byars v Bluff City News Co., 609 F. 2d 843, 846 (6th Cir. 1980).

8 *Id.* at 855.

9 Aspen Highlands Skiing Corp. v Aspen Skiing Co., 738 F. 2d 1509, 1518 n. 11 (10th Cir. 1984), *aff'd* 472 U.S. 585 (1985).

10 *Supra*, note 5.

Monopolists breach s. 2 if their refusal to supply manifests an intent to monopolise. The Court inferred a purpose to monopolise from the circumstances of the case. There was no direct evidence of such an intent.

Similarly, courts have condemned a monopolist's refusal to supply customers who deal with its rivals. Lorain Journal Co. v U.S.¹¹ shows this. The Journal published the only newspaper in Lorain, Ohio. It had a substantial monopoly in advertising in Lorain. A radio station started competing for advertising. The Journal responded by refusing to sell advertising space to any local business which also advertised on the radio station. The Supreme Court held this breached s. 2. The Court held the Journal, by refusing to supply had the plan and desire to injure the radio station. It had no trouble in inferring an intent to monopolise.

Conversely, if the monopolist in refusing to supply does not have the purpose of increasing or maintaining a monopoly or of gaining a direct competitive advantage courts will not condemn the monopolist. Official Airline Guides, Inc. v FTC¹² is illustrative. The defendant published the Official Airline Guide. This was a monthly directory that listed the flights and fares of all scheduled passenger plane transportation in the U.S. The plaintiff was a small commuter airline. The defendant refused to include the plaintiff's airline in the guide. It claimed it did so because it was obliged to provide information on safe and punctual air service. It deemed small commuter airlines, such as the plaintiff's, less reliable and less safe than certified airlines, so it refused to list

11 342 U.S. 143.

12 630 F. 2d 920 (2d Cir. 1980), cert. denied, 450 U.S. 917 (1981).

them. The Second Circuit held that only coercive acts, a purpose to restrain competition or an intent to increase or maintain its monopoly will deprive a monopolist of its right to supply whom it wanted. Here, the defendant's purpose was not anticompetitive. Thus, it did not breach the antitrust laws. The Court ignored that the defendant's policy substantially injured commuter airlines and consumers of airlines. The policy did so by distorting the flow of information to consumers of air carrier services. Anticompetitive effect was irrelevant. Anticompetitive purpose was what mattered.

Another line of cases have focused on the anticompetitive effects of a refusal to deal. Byars v Bluff City News Co.¹³ is an example. Byars distributed periodicals. Bluff City was a regional supplier. Bluff City's ownership changed and it stopped supplying Byars. It claimed it had to, to ensure the strict control necessary for it to qualify for credit for unsold periodicals from its national supplier. The Sixth Circuit restated the Colgate intent test. However, it noted when discussing intent:

"[W]hat should matter is not the monopolist's state of mind, but the overall impact of the monopolist's practices ... [which] should be deemed 'unfair' or 'predatory' only if it is unreasonably anticompetitive".¹⁴

The Sixth Circuit remanded the case back to the District Court to reconsider whether Bluff City possessed monopoly power. It instructed the District Court to weigh the anticompetitive impact of the refusal to deal against the business justification for the monopolist's practices. If Byars could have

13 Supra, note 7.

14 Id. at 860.

showed Bluff City's refusal caused anticompetitive injury, Bluff City could still give business reasons justifying its refusal to supply.¹⁵

Similarly the Eleventh Circuit in Mr Furniture Warehouse, Inc. v Am / Commercial Inc.¹⁶ held:

"A monopolist's refusal to deal becomes actionable . . . only where [it] is designed to have an anticompetitive effect, whether to gain greater market share, to drive up prices or to obtain some other illegal goal".¹⁷

Hampton notes that the Supreme Court's decision in Aspen Skiing Co. v Aspen Highlands Skiing Corp.¹⁸ reconciled the divergent line of cases.¹⁹ Aspen Skiing Co. (Ski Co.) and Aspen Highlands Skiing Corp. (Highlands) operated rival skiing facilities in Aspen, Colorado. Of the four ski-fields in Aspen, Ski Co. owned three and Highlands one. Since 1962 the parties had operated an all-Aspen ticket coupon system. This allowed skiers to ski on any of the four mountains. The parties distributed revenue from the all-Aspen ticket according to the number of coupons collected at each mountain. Highlands generally received 16 to 18 per cent of the revenue. For the 1976-77 season it only received 13.2 per cent. Before the 1977-78, season Ski Co. said it would

15 Id. at 862-863.

16 919 F. 2d 1517 (11th Cir. 1990).

17 Id. at 152; See also Mid-Texas Communications Systems, Inc. v AT & T, 615 F. 2d 1372 (5th Cir.), cert. denied, 449 U.S. 912 (1980); Alameda Mall, Inc. v Houston Lighting & Power Co., 615 F. 2d 343 (5th Cir.), cert. denied, 449 U.S. 870 (1980).

18 472 U.S. 585 (1985).

19 Hampton, Aspects of the Commerce Act 1986, 769, in BUTTERWORTHS COMMERCIAL LAW (J. Farrar & A. Borrowdale eds. 2d ed. 1992).

only continue the all-Aspen ticket if Highlands accepted a fixed percentage of the revenues. Highlands found the percentage offered (13.2 per cent) unacceptable. Ski Co. terminated the all-Aspen ticket. Ski Co. then introduced its own three-mountain ticket. It also started a national advertising campaign that suggested its mountains were the only ski-fields in the area. Highlands tried to market its own all-Aspen ticket. This failed as Ski Co. refused to accept Highland's tickets. It also refused to sell tickets for its mountains to Highlands. Without the all-Aspen ticket, Highland's market share declined to 11 per cent.

Highlands sued, alleging Ski Co. had monopolised the downhill skiing market in Aspen by refusing to co-operate in making the all-Aspen ticket available. A jury found Ski Co. had breached s. 2. The trial judge had instructed the jury that a firm possessing monopoly power has no duty to co-operate with its rival.²⁰ Her Honour further instructed that such a firm, that refuses to supply a rival in some manner does not breach s. 2 if valid business reasons exist for the refusal.²¹

The Tenth Circuit affirmed.²² It held (inter alia) sufficient evidence existed to support the jury's finding that Ski Co.'s intent, in refusing to deal with Highlands, was to create or maintain a monopoly.²³

The issue for the Supreme Court was whether the finding Ski Co. had breached s. 2 as a matter of law, "because it results in the assumption that a firm

20 *Supra*, note 18, at 597.

21 *Ibid.*

22 *Supra*, note 9.

23 *Id.* at 1522.

with monopoly power has a duty to co-operate with its smaller rivals in a marketing arrangement in order to avoid violating s. 2 of the Sherman Act".²⁴ The Court agreed with Ski Co. that "even a firm with monopoly power has no general duty to engage in a joint marketing program with a competitor".²⁵ It rejected Ski Co.'s claim that the jury's decision rested on this proposition, given the trial judge's unambiguous instructions that a firm with monopoly power has no duty to co-operate with its rivals.

The absence of such an unqualified duty to co-operate, according to the Court did not mean that such a refusal to supply "may not have evidentiary significance, or that it may not give rise to liability in certain circumstances".²⁶ Relying on Lorain Journal,²⁷ the Court noted that the right to refuse to supply does not include such refusals when the monopolist has a purpose to create or maintain a monopoly. Ski Co. did not simply reject an offer to participate in a co-operative venture which a rival proposed. Instead, it "elected to make an important change in a pattern of distribution that had originated in a competitive market and had persisted for several years".²⁸ The Court specifically found that interchangeable tickets were used in other ski areas which were competitive, thus permitting the Court to infer that such tickets "satisfy consumer demand in free

24 Supra, note 18, at 587 (footnote omitted).

25 Id. at 600.

26 Id. at 601.

27 Supra, note 11.

28 Supra, note 18 at 603.

competitive markets".²⁹

The Court concluded that Ski Co's decision to end the all-Aspen ticket" was thus a decision by a monopolist to make an important change in the character of the market".³⁰ The trial judge's instructions attempted to distinguish between practices that reflect only a superior product or a well-run business, and the factors and practices that tend to exclude or restrict competition. Thus, the Court considered whether the trial record supported the jury's conclusion that no valid business reasons existed for the refusal to supply Highlands. The linchpin of this inquiry was whether the evidence showed that Ski Co. had been attempting to exclude rivals on some basis other than efficiency. The Court found that the refusal to supply denied consumers their preference for the all-Aspen ticket, adversely affected Highland's ability to compete and was not supported by any efficiency justification. The Court held that:

"[t]he evidence supports an inference that Ski Co. was not motivated by efficiency concerns and that it was willing to sacrifice short-run benefits and consumer goodwill in exchange for a perceived long-run impact on its smaller rival".³¹

The Court suggested a tripartite test for determining whether a monopolist breached s. 2 by refusing to supply:

1. did the monopolist's conduct harm consumers,
2. did the monopolist's conduct hinder rivals' ability to compete,

29 Ibid.

30 Id. at 604 (footnote omitted).

31 Id. at 610-611.

3. did any valid business reasons justify the monopolist's conduct.

Thus, intent and the effect of the refusal to deal are both crucial in determining whether a monopolist breached s. 2 by refusing to supply.

The Aspen decision is consistent with the Raising Rival' Costs theory, more on exclusion of competition than on the monopolist's ability to control price. That focus is central to the theory of raising rivals' costs. However, in a footnote, the Court recognised cost-raising strategies and implied the basis for a cause of action:

"In any business, patterns of distribution develop over time; these may reasonably be thought to be more efficient than alternative patterns of distribution that do not develop. The patterns that do develop and persist we may call the optimal patterns. By disturbing optimal distribution patterns one rival can impose costs upon another, that is, force the other to accept higher costs".³²

Thus, one can read Aspen as lending judicial support to a theory of exclusion based on raising rivals' costs.

The Court characterised the exclusionary conduct in Aspen as designed to harm, exclude or disadvantage a rival and consumers. This type of exclusionary conduct is a paradigmatic example of strategically raising a rival's costs. The termination of the joint venture was more costly to Highlands. This led to a decline in sales to a point where it might have had to leave the market. Ski Co. placed Highlands at a competitive disadvantage by cutting off its access to an essential input or critical mass of consumers.

Thus, Ski Co's conduct was exclusionary. It gained the power over price by raising its rivals' costs. In Bork's words, it "disturbed the optimal patterns of

32 Id. at 604 n. 31 (quoting R. BORK, *THE ANTITRUST PARADOX : A POLICY AT WAR WITH ITSELF*, 156 (2d ed. 1993).

distribution".³³ Terminating the joint venture fits neatly into Krattenmaker and Salop's model. They note:

"[T]he challenged practice may destroy competition by providing a few firms with advantageous access to goods, markets or customers, thereby enabling the advantaged few to gain power over price quality or output".³⁴

Indeed, the RRC theory best explains Aspen. The joint venture benefited Ski Co., yet it terminated it. It thus engaged in inefficient conduct. The only plausible reason is to raise rivals' costs. The refusal to offer an all-Aspen ticket may have hurt consumers and may have discouraged skiers from going to Aspen. However, Ski Co. must have decided it would rather have a bigger share of a smaller market. Although the refusal disadvantaged Ski Co. it disadvantaged Highlands more. This is classic strategic predatory behaviour.

It thus appeared that U.S. Courts in deciding refusal to supply cases, would assess how much a rivals' costs would increase after the refusal and how it affects consumers.

Most cases have focused on whether the monopolist has had a legitimate business justification for refusing to supply.³⁵ The Seventh Circuit Court of Appeals gave Aspen the most detailed attention in Olympia Equipment Leasing Co. v Western Union Telegraph Co.³⁶ Western Union had a monopoly in

33 Id.

34 Krattenmaker & Salop, Anticompetitive Exclusion : Raising Rivals' Costs to Achieve Power Over Price, 96 YALE L.J., 209, 216 (1986).

35 See ABA ANTITRUST SECTION : ANTITRUST LAW DEVELOPMENTS (THIRD), 243 (1992).

36 797 F. 2d 370 (7th Cir. 1986), cert. denied, 480 U.S. 934 (1987).

telex services. It had also leased telex terminal equipment to its customers. When it decided to withdraw from the equipment market, it had a large amount of terminal equipment that it had attempted to sell to its customers. Initially, it had provided its sale force, for distribution to its customers, a list of independent suppliers from whom they could obtain such equipment. It encouraged firms like Olympia to enter the equipment market and sell terminals to Western Union customers. Later Western Union decided it was liquidating its equipment too slowly. It then stopped helping Olympia by refusing to refer customers to Olympia, as it had previously done, and refused to provide it with its customer list. Olympia, without its own sales force, went out of business. Olympia sued alleging breach of s. 2. It won at first instance. The Seventh Circuit reversed. Olympia claimed Aspen required Western Union to cooperate with it by supplying its customer lists. It argued that just as Highlands could not survive without the cooperation of its rival, so Olympia could not survive without Western Union's help. Judge Richard Posner disagreed. He held Western Union had not acted anticompetitively. He noted: "Refusing to act as your competitor's sales agent is not an unnatural practice engaged in only by firms bent on monopolisation".³⁷ He observed that a firm with lawful monopoly power has no general duty to help its rivals.³⁸ He distinguished Aspen:

"If [Aspen] stands for any principle that goes beyond its unusual facts it is that a monopolist may be guilty of monopolization if it refuses to cooperate with a competitor in circumstances where

37 Id. at 379.

38 Id. at 375.

some cooperation is indispensable to effective competition".³⁹

Aspen was distinguishable. In Aspen, Highlands could not compete without being able to offer its customers access to Ski Co.'s larger facilities. Competition required some cooperation. By contrast, Olympia could have recruited a sales force and identified customers itself. The evidence showed vendors who had their own sales forces were able to remain in business without Western Union's help. Cooperation was not necessary for effective competition. In Aspen, Ski Co.'s refusal to cooperate with Highlands was in stark contrast to its own decisions to cooperate with rivals in other ski areas. Rivals in other ski areas had joint ticketing arrangements. This suggested cooperation was an efficient marketing tool. In Olympia Judge Posner pointed to the lack of any "evidence that suppliers of telecommunications equipment customarily provide their own customers with lists".⁴⁰

Moreover, Western Union had a legitimate and procompetitive business justification - it wanted to sell its supply of telex terminals as quickly as possible. Judge Posner observed:

"[A] monopolist cannot be faulted for wanting to sell more output unless he is engaged in some predatory or exclusionary scheme There is no such scheme here; Western Union's long-run design is to get out of the telex terminal market".⁴¹

In Aspen, Ski Co. had no legitimate business justification for its conduct. Judge Posner stressed the effect of the refusal to supply on consumers. The refusal

39 Id. at 379.

40 Id. at 377.

41 Id. at 378.

must harm consumers. If not, it is irrelevant that the conduct harms the rival.

"[T]he lawful monopolist should be free to compete like everyone else; otherwise the antitrust laws would be holding an umbrella over inefficient competitors. "A monopolist, no less than any other competitor, is permitted and indeed encouraged to compete aggressively on the merits"

Today it is clear that a firm with lawful monopoly power has no general duty to help its competitors, whether by holding a price umbrella over their heads or by otherwise pulling its competitive punches".

"Most businessmen don't like their competitors, or for that matter competition. They want to make as much money as possible and getting a monopoly is one way of making a lot of money. That is fine, however, so long as they do not use methods calculated to make consumers worse off in the long run. Consumers would be worse off if a firm with monopoly power had a duty to extend positive assistance to new entrants, or having extended it voluntarily a duty to continue it indefinitely. The imposition of such a duty would make firms that possessed or might be thought to possess monopoly power, however laudably obtained, timid about relinquishing that power, or having done so, timid about competing with new entrants".⁴²

His Honour also stressed that a legitimate business reason was important - if only to rebut a presumption that the monopolist's conduct was anticompetitive. His Honour noted:

"[c]onjoined with other evidence, lack of business justification may indicate probable anticompetitive effect".⁴³

Judge Frank Easterbrook criticises the legitimate business purpose test.⁴⁴

He claims that firms often can offer no justification for their conduct. This does

42 Id. at 375-376 (citations omitted).

43 Id. at 378.

44 Easterbrook, On Identifying Exclusionary Conduct, 61 NOTRE DAME L. REV., 972 (1986); EASTERBROOK Monopolisation, Past, Present and Future, 61 ANTITRUST L.J. 761 (1993).

not mean that their conduct does not enhance efficiency. Economics is slow in understanding business behaviour. Advances in learning may show what was once regarded as purposeless behaviour may actually be efficiency enhancing. Given that, courts should not insist on a legitimate purpose for conduct, as they run the risk of condemning behaviour that may actually be efficiency enhancing. Indeed, two years after Aspen, Professor John Wiley suggested Ski Co.'s behaviour was efficient as it permitted Ski Co. to promote the area more aggressively to skiers who might otherwise visit other ski resorts without fearing that some of the newly attracted skiers would spend their money on Highland's slopes.⁴⁵ As Ski Co. did not raise this argument there was no evidence on which to assess it. With respect, courts should require a reason for behaviour. Wiley's post hoc justification could only be achieved if Ski Co. was consciously pursuing it. Ski Co. knew that its conduct was going to cost it in the short run. Its only purpose must have been to disadvantage Highlands. Also future economists may demonstrate the conduct was harmful. Under Easterbrook's argument consumers would suffer in the form of higher prices until the conduct was shown to be conclusively anticompetitive.

Subsequent Circuit Courts have evaluated refusals to deal on whether the monopolist had a legitimate business purpose in refusing to deal. The Ninth Circuit in Oahu Gas Service v Pacific Resources Inc.⁴⁶ held that even if a monopolist's refusal to supply a rival is based partially on a desire to restrict

45 Wiley, "After Chicago": An Exaggerated Demise? DUKE L.J. 1003, 1005 (1986).

46 838 F. 2d 360 (9th Cir.), cert. denied, 488 U.S. 870 (1988).

competition, no s. 2 violation occurs so long as the monopolist also had a legitimate business justification for its decision.⁴⁷ Other Courts have held the same.⁴⁸ However under the Oahu Gas reasoning a monopolist has to supply a customer, if and only if, it has no business justification for refusing to help its rival. This suggests that Courts will accept a monopolist's proffered justifications. Most Circuits will not. They will assess the justifications and assess whether the conduct was unnecessarily restrictive or not. Paschall v Kansas City Star Co.⁴⁹ is illustrative. Here, a monopolist newspaper publisher vertically integrated into distributing its papers. Once it did so, it refused to supply its previous independent distributors. This put the previous distributors out of business. The Eighth Circuit noted that the specific intent required for liability could not be based on "valid business justifications". It identified two legitimate business reasons for the vertical integration.

1. The ability to set an area-wide uniform retail price to facilitate "in paper advertising" for new subscriptions and simplify subscription collection, and
2. the capability to be more responsive to customer complaints and assure more rapid starts for new subscribers.⁵⁰

However, the Court also noted that refusing to supply after a monopolist's vertical integration could harm competition in three ways:

47 Id. at 368.

48 Drinkwine v Federated Publications 780 F. 2d 735 (9th Cir. 1985), cert. denied, 475 U.S. 1087.

49 727 F. 2d 692 (8th Cir. 1984), cert. denied, 469 U.S. 872 (1984).

50 Id. at 697.

1. by increasing barriers to entry,
2. by facilitating the monopolist's ability to price discriminate,
3. by allowing it to evade rate regulation.

The Court held so long as the defendant's integration did not have "unreasonable anticompetitive effects"⁵¹ on consumers it would not breach s. 2. In other words, it balanced the anticompetitive harm against the benefits of the refusal to supply. The Court held the three concerns with vertical integration did not apply here. The Court stressed legitimate business reasons had to involve efficiency.

"Absent the specific intent to monopolise, a monopolist's legitimate business decision will not be curtailed if those decisions promote the redeeming virtues of competition : lower prices, greater efficiency and innovation and more responsive service".⁵²

Other courts have also stressed a legitimate business purpose has to be linked to efficiency. Paschall implies courts will not automatically accept a monopolist's efficiency justifications. In Kerasotes Michigan Theatres Inc. Co. v National Amusements Inc.⁵³ the Sixth Circuit found no justification for the defendant's leveraging conduct. It rejected the defendant's efficiency claims.

Only one case involving a refusal to supply has addressed the issue in a raising rival's cost framework. Reazin v Blue Cross and Blue Shield of Kansas⁵⁴ involved the health care industry. Blue Cross was a health care

51 Id. at 698.

52 Ibid.

53 854 F. 2d 135 (6th Cir. 1988).

54 899 F. 2d 951 (10th Cir.), cert. denied, 110 S. Ct. 3241 (1990).

provider in Wichita, Kansas. It paid Wesley Hospital in Wichita to treat its patients. Reazin was a national health care provider. It acquired Wesley Hospital and some health care financing companies operating in Wichita. Blue Cross was concerned about competition from Reazin so it decided "to terminate Wesley's contracting provider agreement and reduce the maximum allowable payments it would make to [competing hospitals], thereby increasing Wesley's cost of doing business and causing a shift of Blue Cross patients from Wesley to [the competing hospitals]".⁵⁵ Blue Cross's termination not only injured Wesley but also made other hospitals less willing to enter into relationships with Blue Shield's rivals.⁵⁶

The Tenth Circuit held Blue Cross breached s. 2 as its conduct constituted wilful maintenance of monopoly power. Although the Court did not expressly discuss the raising rivals' costs model, its analysis was consistent with such theories. It noted that Blue Cross's acts caused Wesley to spend money on advertising, to reduce prices to retain market share and to lose patients.⁵⁷ In determining that monopoly power existed, the Court expressly agreed with an expert witness for Reason that Blue Cross's power to exclude competition gave power over price.⁵⁸ The Court held that Blue Cross had:

"[r]estricted the ability of other buyers (competing health care financing organisations) to purchase hospital services on a competitive basis through alternative delivery systems, thereby

55 Id. at 954-955.

56 Id. at 966.

57 Id. at 962.

58 Id. at 970.

restraining competition in the health care financing market ...".⁵⁹

This is the raising rivals' costs scenario. As in Aspen, the Court talked of the plaintiff's conduct disadvantaging its rivals.

U.S. courts have primarily applied the "intent test" to a monopolist refusing to supply a rival. However, U.S. courts have developed an alternative analysis - the essential facilities doctrine.

2. The essential facilities test:

The essential facilities or bottleneck doctrine which deals with a particular type of refusal to deal derives from the Supreme Court's decision in U.S. v Terminal Railroad Association.⁶⁰ This was not even a s. 2 case. It involved s.

1. The Court held that a group of railroads that jointly owned the only terminal in St Louis that could feasibly accommodate traffic from west to east, breached s. 1 by denying their rivals access to the terminal on reasonable terms. The reason was such access was essential to rivals' ability to compete. Building on a series of Supreme Court cases that do not even mention the concept, the Circuit Courts formulated the doctrine.⁶¹

59 Id. at 965.

60 224 U.S. 383 (1912).

61 See Areeda, Essential Facilities : An Epithet in Need of Limiting Principals, 58 ANTITRUST L.J. 841 (1989); Blumenthal, Three Vexing Issues Under the Essential Facilities Doctrine : ATM Networks as Illustration, 58 ANTITRUST L.J. 855 (1989); Goninson, Overview : Essential Facilities and Regulation, 58 ANTITRUST L.J. 871 (1989); Azcuenga, Essential Facilities and Regulation : Court or Agency Jurisdiction, 58 ANTITRUST L.J. (1989); Owen Determining Optimal Access to Regulated Essential Facilities, 58 ANTITRUST L.J. 887 (1989); Ratner, Should There be an Essential Facility Doctrine? 21 U.C. DAVIS

The leading modern case is MCI Communications Corp. v AT&T.⁶² AT&T was then a vertically integrated telephone company controlling most local telephone networks. It refused to allow MCI to interconnect with its local network. The local network was essential if MCI was to compete in the long distance market. The Seventh Circuit held AT&T's local networks were essential facilities and that AT&T had a duty to allow MCI access. It held MCI had proved "that it was technically and economically feasible for AT&T to have provided the requested interconnections and that AT&T's refusal to do so constituted an act of monopolisation".⁶³ The Court stated"

"A monopolist's refusal to deal under these circumstances is governed by the so-called essential facilities doctrine. Such a refusal may be unlawful because a monopolist's control of an essential facility (sometimes called a "bottleneck") can extend monopoly power from one stage of production to another, and from one market into another. Thus, the antitrust laws have imposed on firms controlling an essential facility the obligation to make the facility available on nondiscriminatory terms".⁶⁴

The Court also identified four elements necessary to establish liability under the doctrine.

1. control of the essential facility by a monopolist;
2. a competitor's inability practically or reasonably to duplicate the essential facility;

L. REV. 327 (1988); Werden, The Law and Economics of the Essential Facility Doctrine, 32 ST. LOUIS L.J. 433 (1987); Note, Unclogging the Bottleneck : A New Essential Facility Doctrine, 83 COLUMB. L. REV. 441 (1983).

62 708 F. 2d 1081 (7th Cir.), cert. denied, 464 U.S. 891 (1993).

63 Id. at 1133.

64 Id. at 1132.

3. the denial of the use of the facility to a competitor; and
4. the feasibility of providing the facility.⁶⁵

Numerous Courts have cited these four elements approvingly. However, often elements 3 and 4 are changed. Professor William Tye has reformulated elements 3 and 4 as follows.

3. The denial of the use of the facility or the imposition of restrictive terms ... with the consequence of substantial harm to competition in a relevant market in which the monopolist competes (or would be forced to compete with the plaintiff(s) absent the practice.
4. The absence of a "valid business reason".⁶⁶

The fourth element reflects the Supreme Court's findings in Aspen. Some Circuits have accepted this reformulation. It extends, MCI's narrower inquiry into the feasibility of providing access.

The first element focuses on a monopolist's control of an essential facility. To be essential a facility must be vital to competitive viability. Rivals cannot effectively compete in the relevant market without access to it.

Courts initially applied the term essential facility to tangible items. However, some courts now apply it to intangible assets.⁶⁷

The second element is usually not controversial. However the Seventh

65 Id. at 1132-1133.

66 Tye, Competitive Access : A Comparative Industry Approach to the Essential Facility Doctrine, 8 ENERGY L.J., 337, 346 (1987).

67 Bell South Advertising & Publishing Corp. v Donnelly Information Publishing, 719 F. Supp. 1551 (S.D. Fla. 1988), aff'd, 933 F. 2d 952 (1991).

Circuit addressed it in Fishman v Estate of Wirtz.⁶⁸ Fishman and Wirtz led investment groups which each wanted to buy the Chicago Bulls NBA franchise. Fishman had an agreement to buy the Bulls, contingent on him obtaining a stadium lease. Wirtz, controlled Chicago Stadium and refused to lease it to Fishman. Fishman sued alleging breach of s. 2 on the basis of the essential facilities doctrine. Wirtz alleged that Fishman could have built a new stadium. The Seventh Circuit held Chicago Stadium "was not duplicable without an expenditure that would have been unreasonable in light of the size of the transaction such duplication would have been facilitated".⁶⁹ The Court held that the point of the essential facilities doctrine is that potential market entrants should not be required to enter two markets simultaneously. Wirtz also argued its refusal did not harm consumer welfare. The Seventh Circuit accepted this but held the essential facilities doctrine did not require that. A plaintiff in such a case did not have to show harm to consumers when the conduct was not aimed at the consumer level. The Court did note that the Aspen decision had stated the effect on consumers is significant in labelling conduct exclusionary. However, it did not comment on it.

Judge Easterbrook dissented, saying the case was not an essential facilities case. It was not the usual case of a monopolist refusing to supply a rival with the purpose of disadvantaging it. Chicago could only have one NBA franchise. Thus it was a situation of two firms competing to be the sole monopolist. This did not harm consumer welfare. He chided the majority for not adequately

68 807 F. 2d 520 (7th Cir. 1986).

69 Id. at 539-540.

dealing with Aspen. He did however agree that it was not possible to duplicate the stadium.⁷⁰

It is insufficient for a plaintiff to allege that access to one facility is simply "more economical" than other alternatives.

"An inquiry into the practicality of duplicating the facility should consider economic, regulatory and other concerns. Although expensive in absolute terms, the cost of duplication may be reasonable in light of transactions that would be duplicated and the possible profits to be gained".⁷¹

A defendant may also defeat an essential facilities claim by providing an alternative facility on a reasonable basis.

Generally, it will be no problem for a plaintiff to establish the third element of the essential facilities doctrine. A defendant either has or has not denied access.

The fourth element poses some issues. Although courts do not investigate the anticompetitive effect of refusal of access to an essential facility, they still take account of the reasons for the monopolist's refusals. If they are legitimate courts will not require access. Unlike the legitimate business justifications under the intent test, the essential facilities cases do not require the reasons to be linked to efficiency. Courts will not require access if it is not "technically and economically feasible" for the defendant to provide or share access to the facility in question. Technical reasons have nothing to do with efficiency. The doctrine provides that access must be on "a fair and reasonable basis". This has caused problems as courts have had to set these fair and reasonable prices. The cases

70 Id. at 570-574.

71 Id. at 540.

present no discernable pattern. However, one constant is that any fee has to have a component which compensates the defendant who initially invested in the facility.⁷²

One student note has suggested a defendant only has "three narrowly drawn defences" for refusing access.

1. the limited capacity of the facility,
2. the inability or unwillingness of the foreclosed party to bear the monopolist's cost in providing access,
3. interference with the monopolist's service of other customers.⁷³

This corresponds with the case law. The essential facilities doctrine does not apply if the monopolist does not compete with the plaintiff. U.S. courts regard these as arbitrary refusals to deal. No antitrust liability attaches. The only exception is if the refusal to supply is to prevent discounting. Then, however, the conduct is *per se* illegal as resale price maintenance. Such cases do not involve the raising rivals' costs theory. A firm cannot raise its rivals' costs if it refuses to supply someone who is not a rival.

The courts do not speak of raising rivals' costs when dealing with essential facilities. Seeing they do not consider the anticompetitive effect of a refusal to supply in such circumstances, this is not surprising. However, one can analyse such cases on that basis. By denying a rival access to an essential facility, a firm must raise its rivals' costs.

It is still uncertain whether the Supreme Court will endorse the essential

72 *Supra*, note 60.

73 Note, *supra*, note 61, at 474-477.

facilities doctrine. It had the opportunity of addressing the issue in Aspen. It declined to do so - deciding the case under the intent test.

The RRC model is relevant and useful in assessing refusals to deal under U.S. law. I now turn to Australian and New Zealand law. I shall not discuss whether s. 36 and s. 46 allow the essential facilities doctrine. The issue is beyond this dissertation's scope. Other commentators have already addressed the issue.⁷⁴

Australian and New Zealand Law:

Much Australian case law involves a firm refusing to supply (or terminating) one of its distributors. Such refusals can breach s. 46. However, they do not involve the Raising Rivals' Costs analysis. A firm by refusing to supply one of its own distributors does not and cannot raise its rivals' costs. Accordingly, I shall not consider such cases.⁷⁵

The leading Australian case is OWI. I have considered this already under the price squeeze chapter. I have argued the RRC is relevant to the case. Most other Australian cases involve exclusive dealing. I shall consider those in the exclusive dealing chapter. A significant refusal to deal case not involving exclusive dealing as such, is TPC v CSR Limited.⁷⁶

CSR was Australia's largest manufacturer of plasterboard and associated

74 See authorities cited in GAULT ON COMMERCIAL LAW, para 36, 09 (8) (1994).

75 See McMahon, Refusals to Supply by Corporations with Substantial Market Power, 22 ABLR 7 (1994).

76 (1991) ATPR, para 41-076.

products. (These materials are used to construct ceilings.) It was the sole supplier in Western Australia. Its largest Western Australian wholesale customer was North Perth Plaster Works Pty Ltd (North Perth). Until January 1987 North Perth bought all of its plasterboard from CSR. North Perth then began to acquire plasterboard from a new entrant - Boral Australian Gypsum Limited (Boral). North Perth intended to sell Boral products from a new warehouse. It wanted to sell CSR products from its existing outlets. CSR informed North Perth that it would only supply wholesalers who carried a full range of its products. North Perth could not carry a full range of both Boral and CSR products. It wanted "access" to any CSR products which a customer expressly requested. CSR wrote to North Perth refusing to supply stating it was not prepared to supply its product to a wholesaler who was going to use its products to supplement Boral's product line or to "top up" Boral's shortfalls in supply. North Perth complained to the Trade Practices Commission. The Commission sought an injunction and pecuniary penalties against CSR alleging breach of s. 46 and s. 47. CSR admitted liability. French J. held that the effect of CSR's letter was to announce a refusal to supply. Its purported reasons for refusal were a sham and a device to stop North Perth claiming breach of the Trade Practices Act. French J. commented, that CSR's behaviour was reprehensible in that it aimed its conduct at Boral when Boral was seeking to enter the market through North Perth. North Perth was vulnerable to a cessation of supply from CSR. This was especially so given CSR's market power and the geographical isolation of the market and the associated barriers to entry.

One can analyse this under the RRC analysis. North Perth was necessary

for Boral to compete in the Western Australian market. The input market is plasterboard wholesalers. By refusing to supply North Perth if it carried Boral products, CSR entered into an exclusionary rights contract with North Perth. This raised Boral's costs. Boral had to find another wholesaler. Given the geographical isolation very few probably existed in Western Australia. This is the bottleneck or real foreclosure scenario. CSR as the sole supplier had power over price. Consumers could not obtain plasterboard from anywhere else in Western Australia. The only substitutes were presumably more expensive supplies from other states. Thus the RRC model is relevant in this case of refusal to supply.

New Zealand:

The same situation applies in New Zealand for refusals to supply as in Australia. The RRC model is only relevant if a dominant firm refuses to supply a rival. Thus, I shall not consider ARA v Mutual Rental Cars⁷⁷ case. This did not involve the ARA refusing to supply a rival. Interestingly, Barker J. analysed the case under the essential facilities doctrine. U.S. Courts would not consider this as an essential facilities case as the person controlling the essential facility did not refuse access to a rival.

None of the cases involving the Milk Board terminating its vendors involve the RRC model either. By terminating milk supplies the Board did not raise the vendors' costs. They stopped them obtaining milk. They could not obtain it elsewhere. This is a possible essential facilities case. None of the

77 [1987] 2 NZLR 647.

Courts raised this possibility.

I have already considered the two leading New Zealand refusal to supply cases - Port Nelson⁷⁸ and Clear v Telecom⁷⁹ in the Price Squeeze chapter. I concluded the model was applicable. The same reasoning applies.

The Aspen case is relevant to New Zealand. The Aspen specific intent is very similar to the purpose requirements under s. 36. The idea of disadvantaging a rival in Aspen corresponds to the deterring purpose under s. 36(1)(c). I have argued the RRC theory best explains Aspen. Given the similarity between Aspen and s. 36 the RRC model will likely be influential in New Zealand.

Conclusion:

The RRC model aids analysis of some types of refusal to deal. It does not apply when a dominant firm refuses to supply a non-rival. Nor is it very useful in the context of the essential facilities doctrine. One of the keys to the model is the effect raising rivals' costs has on consumers. The doctrine as it stands does not consider this. The model is useful and relevant to s. 36 when a dominant firm refuses to supply a rival.

78 [1990] 2 NZLR 662.

79 Unreported. 17/12/93 CA 25/93.

CHAPTER VIII

OVERBUYING AND PREEMPTIVE INVESTMENT

Introduction:

Overbuying is a classic RRC strategy.¹ A predator buys up more of an input than it needs. It, in Krattenmaker and Salop's words, enters into Exclusionary Rights Contracts with existing input suppliers. This is the Real Foreclosure scenario. A predator buys so much of an input that it forces up the price of the remaining available input. This raises its rivals' costs. Closely linked to overbuying is the strategy of preemptive investment. Here, a predator expands its capacity before demand for its product increases. By expanding capacity the predator will be using more input to manufacture its product. This will mean less of the input is available to rivals. This will drive up the price for the input, thus raising rivals' costs. However, the notion of overbuying and preemptive investment being anticompetitive is controversial. Part II of this chapter will examine its attractions as an anticompetitive strategy. Part III will discuss the criticisms of overbuying and preemptive strategy. Part IV will discuss the case law such as it is. Part V will discuss whether the strategy could breach s. 36. Part VI will offer some conclusions.

1 Krattenmaker & Salop, Anticompetitive Exclusion : Raising Rivals' Costs to Achieve Power over Price, 96 YALE L. J., 209, 236-237 (1986).

Attractions as an Anticompetitive Strategy:

The idea underlying the strategy is that firms choose capacity in a strategic way so as to deter entry. Professor Michael Spence has developed a detailed model of entry-detering capacity.² According to Spence, if a firm wants to maintain market power and high profitability over an extended period of time it must develop some form of protection from existing or potential rivals from expanding. If it wants to protect its position in the sun it must be able to deter entry from new rivals and expansion from existing rivals. A firm can take two kinds of action. The first kind are actions a firm takes before a new rival enters the market. Spence calls these pre-entry actions positioning. The second kind are action takes in response to entry, i.e. after a rival has entered. Spence calls these post-entry actions reactions.³

The key for a predator to deter entry is to find a positioning strategy that is -

- (1) not too costly, and
- (2) creates the incentive for the predator to react to the entrant in a way that

2 Spence, Entry, Capacity, Investment and Oligopolistic Pricing, 8 BELL J. ECON., 534 (1977); Spence, Investment Strategy and Growth in a New Market, 10 BELL J. ECON. 1 (1979); Dixit, A Model of Duopoly Suggesting a Theory of Entry Barriers, 10 BELL J. ECON., 20 (1979); Prescott & Ursscher, Sequential Location Among Firms with Foresight, 8 BELL J. ECON. 378 (1977); Salop, Monopolistic Competition with Outside Goods, 10 BELL J. ECON. 141 (1979); Schmalensee, Entry Deterrence in the Ready-to-Eat Breakfast Cereal Industry, 9 BELL J. ECON. 305; Eaton & Lipsey, Exit Barriers are Entry Barriers : The Durability of Capital as a Barrier to Entry, 11 BELL J. ECON. 721, 728 (1980).

3 Spence, Competition, Entry and Antitrust Policy, 17 J. REPRINTS ANTITRUST L. ECON., 51, 53 (1981).

is destructive to the latter.

Preemptive investment is one such positioning strategy. The predator chooses a capacity so large that a new entrant could make no sales at a profitable price if the predator used all of its capacity. The excess capacity is wasteful. However, the predator views it as an investment. It will benefit the predator if the investment does not use all of the predator's monopoly profit. It retains some monopoly profit after adding the capacity. If it had not added the capacity, or only added an amount which would have allowed entry, the new entrant would have eliminated its monopoly profits. Consequently the predator will preserve its position and in the process turn most of the monopoly profit into socially wasteful costs.⁴ The predator is rent seeking by adding capacity.⁵

Spence's model is not confined to the manufacturing industry. A predatory retailer may also engage in expansion-detering investment. It may "over-store" a geographic area to limit rivals expanding.⁶

Similarly, a predator may use the strategy in a reactions way. The added

4 Posner, The Social Costs of Monopoly and Regulation, 83 J. POL. ECON., 801 (1975).

5 Id. Posner, argues one of the costs of monopoly is that the existence of an opportunity to earn monopoly profits will attract resources into competing for those profits. The opportunity cost of these resources is a social cost of monopoly. The effect of this activity is to turn the whole of monopoly profits into social costs, since firms will incur costs in order to obtain a monopoly position until the costs incurred equal the expected return from the position. For an appraisal of Posner's theory see Fisher, The Social Costs of Monopoly and Regulation : Posner Reconsidered, 93 J. POL. ECON., 410 (1985).

6 See Campbell, Predation and Competition in Antitrust : The Case of Nonfungible Goods, 87 COLUMB. L. REV. 1625 (1987); Hotelling, Stability in Competition, 39 ECON. J. 41 (1929).

capacity will deter existing rivals from expanding. They will know the predator already has excess capacity. Thus, if they try and expand, they will fail as the predator has the ability to increase output and reduce price. Thus, the rivals' profits will be zero if they expand.

The strategy is a powerful signalling device.⁷ It signals to potential and existing rivals that the predator has made an irreversible and preemptive commitment to the industry. It also signals potential entrants that the predator has the ability to engage in a price cutting war once a new firm enters the market. That signalling may induce rivals to leave the market and persuade others not to enter. The signal that the predator can engage in a price cutting war may be incorrect. The capacity expansion may have exhausted the predator's financial resources. That does not mean rivals will not take any notice of the signal. Asymmetric knowledge characterises market. Firms do not have perfect knowledge.⁸ Rivals will not know that the predator has exhausted its resources and cannot afford to price cut. Thus, they will take the signal seriously. This is especially so if the predator has a reputation for responding vigorously to competition. Once a firm has established such a reputation it does not have to repeat the demonstration very often. It need only do it once.⁹

7 Gale & Hellwig, Incentive-compatible debt contracts : The one-period problem, REVIEW OF ECONOMIC STUDIES, 52 (1986); Fudenberg & Tirole 'The Fat-Cat Effect, the Puppy-dog Ploy and the Lean and Hungry Look', 74 AM. ECON. REV., 361 (1984).

8 See Krebs & Wilson, Reputation and Imperfect Information, 27 J. ECON. THEORY, 253 (1982); Milgrom & Roberts, Predation, Reputation and Entry Deterrence, 27 J. ECON. THEORY 280 (1982).

9 R. POSNER, ANTITRUST LAW : AN ECONOMIC PERSPECTIVE, 184-187 (1976); Williamson, Predatory Pricing : A Strategic and Welfare

Thus, although the signal may be false rivals will take it seriously. Professors Drew Fudenberg and Jean Tirole call falsely signalling that the predator is superior in some important way the "signal-jamming theory of predation".¹⁰

Professor Michael Porter building on Spence's work has identified five conditions which must exist before the strategy can succeed.¹¹

1. The capacity expansion must be large relative to the expected market size.¹²

If the capacity expansion is not large it cannot be preemptive. A key related issue is what does each rival and prospective think future demand will be? If any rival believes that future demand will be large enough to absorb the capacity expansion and then some, it can choose to enter or expand. To prevent rivals thinking this, the capacity expansion must be large.

2. There must be large economies of scale relative to total market demand.¹³

If economies of scale are large relative to total market demand, an early preemptive capacity expansion may deny rivals enough residual demand to be efficient. If so, rivals who invest must invest heavily and risk a costly struggle to fill capacity. If not, they will have inherently higher costs if they invest on a

Analysis, 87 YALE L. J., 284 (1977).

10 Fudenberg & Tirole, A Signal-Jamming Theory of Predation, 17 RAND J. ECON., 366 (1986).

11 M. PORTER, COMPETITIVE STRATEGY : TECHNIQUES FOR ANALYSING INDUSTRIES AND COMPETITORS, 335-338 (1980).

12 Id. at 336.

13 Ibid.

small scale.

3. The Predator's Capacity Expansion must be credible.¹⁴

Rivals must believe a predator when it announces it is committed to and able to expand capacity. Some of the factors which will give the predator credibility are its level of resources, past record of expanding capacity and financial stability and backing.¹⁵ Without such credibility, rivals will not view the expansion preemptive or they may decide to take on the predator.

4. The predator must be able to signal its preemptive motive before rivals can respond.¹⁶

A predator must be able to signal that it is preemptively expanding capacity before rivals have committed themselves to expand. If not rivals will expand anyway. They will have financially committed themselves to do so.

5. Rivals must be willing to back down.¹⁷

The strategy assumes rivals will balance the potential rewards of fighting the predator against the risks and conclude the risk is not worth it. Some rivals will not. This is especially so, if the rivals have made their own heavy investments. Some rivals will have equal or longer staying power than the predator. The strategy is best against a potential rival or a small existing rival.

14 Id. at 337.

15 Id. at 201.

16 Id. at 337.

17 Id. at 338.

Critique:

Expanding capacity beyond anticipated demand is conceptually similar to predatory pricing. The predator has expanded by adding new facilities when it has no reasonable expectation that the revenue from those new facilities will cover its costs. As such the criticisms of predatory pricing are the same as those for preemptive expansion capacity.

First some commentators claim the strategy is not rational. Areeda and Turner argue the costs of the strategy versus the anticipated gains are so speculative that, like predatory pricing, the likelihood of such conduct is remote.¹⁸

Easterbrook argues that the strategy cannot work if demand is growing.¹⁹ A predator may not have been able to meet the actual demand when it previously expanded capacity.

The most common criticism is that it is impossible to distinguish between a predatory expansion and an expansion based on a reasonable anticipation of increased demand, i.e. it is impossible to distinguish between predatory expansion and efficient expansion.²⁰ Demand may be increasing. A firm will need to expand. A rational firm will want to expand to meet that demand. It may want excess capacity in case demand increases even more. The market may change. Demand may decrease. The firm that expanded may look like a

18 P. AREEDA & D. TURNER, *ANTITRUST LAW*, 180-181 (1978).

19 Easterbrook, *Predatory Strategies and Counterstrategies*, *U. CHI. L. REV.*, 263, 291-293 (1981).

20 *Id.* at 295; AREEDA & TURNER, *supra*, note 18, at 180.

predator that has added extra capacity. In reality it was trying to be efficient and was caught out by the market changing. Similarly a large capacity increase may be due to new cost-saving technology. Condemning such expansion would be condemning efficiency. It may also deter future innovation in such technology. Despite the criticism Areeda and Turner recognise predatory expansion can cause concern:

"Ordinarily, expansion of capacity to meet existing or anticipated demands is socially desirable behaviour, it is one of the most important responses that we expect a well-functioning market to generate. Expansion to meet anticipated demands is questionable only if consciously carried out well in advance of needs".²¹

They give an example where antitrust should intervene. The owner of a town's only theatre may build a second theatre. He does not open that theatre for five or 10 years. The only function of the new but unused capacity is to intimidate possible new entrants.²²

Most of this criticism arose before Krattenmaker and Salop developed the RRC model. This removes the objection that the anticipated gains of capacity expansion are speculative. As mentioned above, expanding capacity is a form of overbuying. This raises rivals' costs. If the cost rises cause a predator to gain power over price it will be able to finance the expansion out of the revenue it saves by preventing prices falling. Professor William Baxter indirectly acknowledges this when he notes that one of the only two ways exclusive dealing can cause anticompetitive harm is when a manufacturer "preemptively buys up more distribution capacity than it really needs and thus confronts rivals when an

21 AREEDA & TURNER, *supra*, note 18, at 21.

22 *Id.* at 181.

artificial shortage of distributional facilities causing its rivals to have to pay too much for their facilities as a consequence of the shortage".²³ Professor Baxter notes this will mean rivals will supply less product and the manufacturer will face a more inelastic demand curve. This means the manufacturer has prevented prices falling. It can pay for the expansion by the money it saves by having prevented price falling.

Although the strategy pays for itself over the long run, it may cost the predator in the short run. This does not destroy the theory as some Chicago School scholars contend.²⁴ The purpose of the strategy is to influence rivals' behaviour. It need not be rational in the short run. Predation is usually only rational in the long run, in terms of increased present values of profits, when it convinces rivals and potential entrants that the predator will carry through on its commitment in the future. While the strategy costs the predator in the short term it pays for itself in the long run by giving the predator power over price. If the predator convinces a rival to leave and also convinces others not to enter, its profits will be generally higher. In such a case the predator has not only gained power over prices by raising rivals' costs it has eliminated existing rivals. This is a double blow for consumer welfare. Thus, with respect Chicago School scholars are incorrect in requiring strict rationality at every point in time when explaining predation.

However, the problem of distinguishing between efficient expansion and

23 Baxter, Brief of Evidence in Fisher & Paykel Ltd v Commerce Commission [1990] 2 NZLR 731, 10-11 (1990).

24 Easterbrook, *supra*, 19.

predatory expansion remains. I now turn to how courts have dealt with the problem.

Case Law:

The case law on the issue is scarce. The first and most famous case is U.S. v Aluminium Co. of America²⁵ (Alcoa). The U.S. Justice Department alleged that Alcoa monopolised the aluminium market by (inter alia) by expanding its capacity to meet demand. Judge Learned Hand held it did. He commented:

"The only question is whether [Alcoa] falls within the exception established in favour of those who do not seek, but cannot avoid, the control of a market. It seems to us that that question scarcely survives its statement. It was not inevitable that [Alcoa] should always anticipate increases in the demand for ingot and be prepared to supply them. Nothing compelled it to keep doubling and redoubling its capacity before others entered the field. It insists that it never excluded competitors, but we can think of no more effective exclusion than progressively to embrace each new opportunity as it opened, and to face every newcomer with new capacity already geared into a great organisation, having the advantage of experience, trade connections and the elite of personnel".²⁶

Alcoa did not involve the classic predatory expansion. It did not expand in advance of demand. It expanded in response to demand. Not surprisingly commentators have severely criticised the decision. Bork,²⁷ Areeda and

25 148 F. 2d 416 (2d Cir. 1945).

26 Id. at 431.

27 R. BORK, THE ANTITRUST PARADOX : A POLICY AT WAR WITH ITSELF, 165-170 (2d ed. 1993).

Turner²⁸ among others argue Judge Hand condemned Alcoa for acting like a competitor rather than as a monopolist. A monopolist would decrease output. Alcoa did the opposite - it built new plants to meet demand. Areeda and Turner say it was "absurd" for Judge Hand²⁹ to call expanding capacity to meet estimated demands as exclusionary.

Despite this severe criticism one court followed Alcoa In: Philadelphia World Hockey Clubs Inc. v Philadelphia Hockey Club Inc.³⁰ The Federal District Court found that the National Hockey League's (NHL) expansion into new cities was relevant in showing the NHL's intent to monopolise the U.S. professional hockey market.³¹

"Secondary evidence of the NHL's intent to maintain its control over professional hockey is its continuing policy of expansion tied to the increasing demand for hockey in the United States and also in Canada. Of course, if ever this burgeoning interest in hockey in North America could nonetheless support only one supplier, then this court would be bound to conclude that the NHL enjoys a "natural monopoly".³²

Since the Court could not determine whether only one hockey league could survive, it held, relying on Alcoa, that the NHL's expansion was evidence of intent to monopolise.³³ Other courts expressly declined to follow Alcoa.³⁴

28 AREEDA & TURNER, *supra*, note 18, at 18-22.

29 *Id.* at 22.

30 351 F. Supp. 462 (E.D. Pa. 1972).

31 *Id.* at 511-513.

32 *Id.* at 511.

33 *Id.* at 511-513.

A case that involved an alleged predatory expansion was E.I. du Pont, de Nemours & Co.³⁵ du Pont had aggressively expanded its titanium dioxide capacity. The FTC investigated. However, it dismissed its own complaint. du Pont's expansion was not part of a predatory strategy, but rather due to it having pioneered a large-scale but cost-saving technology in extracting titanium dioxide.

Judge Richard Posner dealt a death blow to Alcoa in Olympia Equipment Leasing Co. v Western Union Telegraph Co.³⁶

"Opinion about the offense of monopolization has undergone an evolution. Forty years ago it was thought that even a firm with a lawful monopoly ... could not be allowed to defend its monopoly against would-be competitors by tactics otherwise legitimate; it had to exercise special restraint - perhaps, indeed, had to hold its prices high, to encourage new entry. So Alcoa was condemned as a monopolist because it had assiduously created enough productive capacity to supply all new increments of demand for aluminium; it would not have been condemned if by keeping its prices high it had kept demand down to a level that it could supply without increasing its capacity. Later, as the emphasis of antitrust policy shifted from the protection of competition as a process of rivalry to the protection of competition as a means of promoting economic efficiency. It became recognized that the lawful monopolist should be free to compete like everyone else; otherwise the antitrust laws would be holding an umbrella over inefficient competitors".³⁷

Judge Posner is not suggesting predatory expansion does not occur. He is saying Alcoa's behaviour of expanding to meet demand does not breach the

34 Hiland Dairy, Inc. v Kroger Co., 402 F. 2d 968, 976 (8th Cir. 1968) ("[t]he only case condemning internal expansion is [Alcoa], cert. denied, 395 U.S. 961 (1969); Berkey Photo, Inc. v Eastman Kodak Co., 603 F. 2d 263 (2d Cir. 1979), cert. denied, 444 U.S. 1093 (1980).

35 96 F.T.C. 650 (1980).

36 797 F. 2d 370 (7th Cir. 1986), cert. denied, 480 U.S. 934 (1987).

37 797 F. 2d at 375 (citations omitted).

antitrust laws. Alcoa was not predatorily expanding capacity. Indeed, Judge Posner developed the theory of rent seeking which is crucial in showing why predatory expansion is harmful.³⁸ While expanding capacity can be a normal efficiency enhancing action, it can also be a strategic action designed to hinder or even eliminate rivals. The key difference is the purpose of the capacity expansion. With that in kind I now turn to examine whether capacity expansion can breach s. 36.

Section 36 and Capacity Expansion:

No New Zealand or Australian Court has considered whether expanding capacity breaches s. 36 and s. 46. However, it could be.

Expanding or overbuying when a firm has no need to is conduct which only a dominant firm could find rational. Only a dominant firm could afford to do so. Thus, expanding capacity should meet the Electricorp³⁹ test for use.

The real issue is whether a plaintiff could meet the s. 36 purpose limb. Applying the RRC model can establish whether the alleged predator has gained power over price. This would be useful in inferring an anticompetitive purpose. If the RRC model showed that the dominant firm could not gain power over price a court should stop there and find in favour of the dominant firm. No anticompetitive harm is likely. Antitrust should not be interested. However, this would not be enough. A court would have to consider how the alleged predator

38 Posner, *supra*, note 5.

39 [1992] 2 NZLR 641.

has been able to expand. If, as in the du Pont case,⁴⁰ it was due to a new large-scale, but cost-saving technology courts should not condemn the alleged predator. To do so would chill innovation. It is likely such innovation would not be a use. The dominant firm has acted in such a way that any firm in a competitive market could. It has developed a new technology. That is the whole basis of dynamic efficiency, i.e. small firms will innovate more than dominant ones.

Nor should a court condemn if the dominant firm can show it believed demand was going to increase. If so it was acting like Alcoa. Expanding in the belief that demand is going to increase is rational behaviour. A firm in a competitive market will do the same. However, a court should just not blindly accept such an explanation from a dominant firm. It should assess whether the dominant firm had valid reasons for its belief. If not, the purpose for the expansion is likely.

Section 36(1)(c) is extremely relevant here. As mentioned above, the anticompetitive effect of capacity expansion (indeed of all strategic behaviour) is to disadvantage or deter rivals. It may not eliminate rivals. This is exactly the purpose s. 36(1)(c) condemns. The subsection does not require the elimination of rivals. A dominant firm will argue that its purpose for expanding was not anticompetitive. It will argue it was doing it to make itself better prepared to take advantage of any increased demand in the future. The RRC model and Spence's work show such expansion can harm rivals.⁴¹ If the factors, I

40 *Supra*, note 35.

41 *Supra*, note 2.

mentioned above, are not present courts should be able to infer that a substantial purpose, under s. 2(5)(b), was to deter rivals.

Conclusion:

Expanding capacity or overbuying can, in certain circumstances, cause anticompetitive harm. It is worthy of antitrust concern. The RRC model identifies those circumstances. Section 36 can condemn predatory expansion. The RRC model is extremely useful for courts considering a capacity expansion or overbuying claim under s. 36. It is relevant.

CHAPTER IX

PREDATORY INNOVATION

Introduction:

Economists have argued that product innovation can be a means of predation.¹ A predator can introduce a new product, not as part of normal competition, but as a means of disadvantaging rivals. The theory of raising rivals' costs is crucial in understanding how innovation may be predatory. An example best illustrates this. In Berkey Photo, Inc. v Eastman Kodak Co.² Berkey claimed (inter alia) that Kodak had introduced new film which rival photo-finishers could not process without purchasing new equipment. This raised the costs of the rival photo-finishers. Although the Second Circuit remanded the case for further factual determination it held Kodak could breach the antitrust laws if Berkey showed Kodak had used its market power to gain a competitive

1 Ordoover & Willig, An Economic Definition of Predation : Pricing and Product Innovation, 91 YALE L. J., 8 (1981); Ordoover, Sykes & Willig, Predatory Systems Rivalry : A Reply, 83 COLUM. L. REV., 1150 (1983); Ordoover & Willig, An Economic Definition of Predatory Product Innovation in STRATEGY PREDATION AND ANTITRUST ANALYSIS 300 (S. Salop ed. 1981); For economic literature on patenting (which I do not discuss) see Gilbert, Sleeping Patents, and Entry Deterrence in STRATEGY, PREDATION AND ANTITRUST ANALYSIS 205 (S. Salop ed. 1981); Gilbert & Newberry, Preemptive Patenting and the Persistence of Monopoly, 72 AM. ECON. REV., 514 (1982).

2 603 F. 2d 263 (2d Cir. 1979), cert. denied, 444 U.S. 1093 (1980).

advantage.³ Other U.S. Courts have also found that innovation can be a means of predation.⁴ This idea, is however extremely controversial. Antitrust embodies a strong policy favouring innovation. Critics (and Courts) contend that allowing innovation as a means of predation "chills" or "stifles" innovation. However, it is economically possible and plaintiffs bring cases alleging predatory innovation. Part II of this chapter outlines the main theory of predatory innovation -- viz., Professor Jansuz Ordoover and Robert Willig's theory of predatory product innovation. Although this is not the strict RRC model, raising rivals' costs is a key component of it. Part III critiques the theory. Part IV examines U.S. law on predatory innovation. As no New Zealand case law yet exists, Part V discusses whether s. 36 applies to predatory innovation. Part VI offers some conclusions.

Predatory Product Innovation:

Product innovation, according to Ordoover and Willig can be either predatory or competitive.⁵ They argue courts must distinguish between predatory and competitive innovation. Even, true innovation, such as a superior new product, can be predatory. Courts should condemn such a product if introducing it is only possible because other firms exit the market. They apply this test to all product innovations, especially where a firm introduces new

3 Id. at 282.

4 See *infra*, see also Hurwitz & Kovacic, Jidicial Analysis of Predation : The Emerging Trends, 35 VAND. L. REV., 113-124 (1982).

5 Ordoover & Willig, An Economic Definition of Predation : Pricing and Product Innovation, 91 YALE L.J., 8 (1981).

components to its system. They propose a two-step test for predatory innovations. First they examine structural market factors to determine whether a firm can exercise market power. Second they consider other factors to determine predatory effect on intent.

General Test for Predatory Innovation

Subject to structural market assumptions, Ordover and Willig argue predatory innovation occurs when an innovation is profitable only if firms exist as a result.⁶ Innovation may cause a rival to exit, but it is only predatory if it would not be profitable without the monopoly power resulting from the exit.

Markets which may lead to predatory innovation have three structural characteristics:

1. They must be significantly horizontally concentrated. If not monopoly, profits will not result on the exit of a rival.
2. They must have significant "entry hurdles". These occur when investments are not fully reversible.⁷ They are entry barriers that cost-disadvantage a potential entrant, relative to the incumbent, solely because the incumbent is already in the market.⁸ Without entry hurdles, a firm has no incentive for predation as both potential entrants and existing rivals constrain the incumbent.

6 Id. at 9.

7 Id. at 11; See also Oliver Williamson who stresses the importance of irreversible investments to competition, O. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM*, 52-56 (1985).

8 Ordover & Willig, *supra*, note 4, at 11.

3. They must have "re-entry barriers". These are the costs that a firm which has left the market must meet to resume production. Predation is not viable if a firm that leaves the market can subsequently re-enter without significant costs. If not, the firms that exited, constrain the incumbent. Re-entry barriers are significant when entry requires dispersal or depreciation of essential assets, e.g. personnel, advertising, goodwill, reputation and equipment.⁹

If significant horizontal concentration, entry hurdles and re-entry barriers do not exist the inquiry stops there. It is unnecessary to examine allegedly predatory innovation for anticompetitive effect or intent as a firm, in such a market, has no incentive to predatorily innovate. The structural test determines whether the possible gains from predation can outweigh the costs to the producer of the allegedly predatory innovation. If a market meets the structural test, the model focuses on whether the alleged predator innovated because of the exit the innovation caused.

Two types of innovation can be predatory:

- (1) introducing substitute products, and
- (2) "systems rivalry" or manipulating the components in a system to cause rival component suppliers to exit.

The general test for both types of innovation is whether a predator can recoup research and development costs through profits on the new product. This assumes the continuing viability of rivals.¹⁰

9 Id. at 12.

10 Id. at 15.

Introduction of Substitute Products:

A firm has to make a number of fundamental decisions when introducing a new product. These include timing, price, research and development, advertising and adjustments in price and characteristics of existing products. The Ordoover-Willig model assesses each of these factors singly and jointly as components of the overall innovation strategy.

Introducing a new product can be anticompetitive and predatory. It may often be more effective than predatory pricing in causing rivals to exit. The greater effectiveness is due to the largely fixed and irreversible costs a firm incurs in introducing a new product. As in capacity expansion, a firm's investment in research and development and other sunk costs sends a signal to rivals of the innovators long term commitment to the market.¹¹ This can cause rivals to exit. On the other hand, predatory pricing is not permanent. A rival refusing to exit may convince the predator that it intends to stay in the market. This will cause the predator to cease predatory pricing.

The Ordoover-Willig model works as follows. A dominant producer of a product introduces a new and superior model. The new model's price is low enough to cause consumers to change from previous models, among which significant competition occurs. Facing declining sales, and revenue, rival producers may abandon making the product and sell their productive assets. After the rivals exit, the innovator raises the price and earns monopoly profits. Entry hurdles and re-entry barriers protect the innovator.

Successful predatory innovation and predatory pricing are similar. Both

11 See, Chapter VIII.

involve the short term sacrifice of profit which causes exit and thus permits higher long term profit. Predatory innovation does this by increasing the perceived quality of the profit rather than by decreasing price.

Ordover and Willig say, in order not to "chill" innovation, courts would have to examine predatory product introduction closely. Short term profit sacrifice, high horizontal concentration, entry hurdles and re-entry barriers alone will not establish a claim of predatory product innovation. The predator's product introduction must also substantially increase the likelihood of a rival exiting. A plaintiff must therefore establish the defendant's purpose for predatory innovation. As firms have an uncertain return on research and development investments, Courts must assess the innovator's conduct in terms of expected returns and not after the fact. Thus, that the innovation turned out to be profitable only because a rival exited does not suffice to establish liability.

The RRC model would not require rivals to exit. It is enough if the new product causes the rivals' costs to rise sufficiently to give the predator power over price. Thus, the RRC model is not as strict as the Ordover-Willig model for predatory product innovation.

Predatory Systems Rivalry:

Ordover and Willig say their predatory innovation standard best applies to "systems rivalry".¹² This occurs where a predator innovates in order to extend the predator's market power to another component in the system.

The model can be shown as follows: Firm A manufactures a product

12 Ordover & Willig, *supra*, note 4, at 19.

system with two components, A1 and A2, which it sells separately. Firm A has monopoly power over A1. Firm B competes in the market for component A2 with its compatible component, B2. Consumers can therefore choose a product comprising either A1 and A2 or A1 and B2. An example is computers. A single personal computer (A1) can be used with two different printers (A2 and B2).

Firm A then introduces a new product system, A1¹ and A2¹. This serves the same function for consumers as its former A1 and A2 system. Component B2 is, however, incompatible with A1¹. Furthermore, firm A stops selling A1 or reprices A1 significantly higher than before. Using the computer example, the computer company stops making its old personal computer and introduces a new personal computer that is compatible only with its printer, not with its rival's printer. As a result, consumers switch to the new product system and firm B loses substantial sales of its product B2. If A's innovation causes B to lose enough sales, B will eventually leave the market, giving A the power to price above marginal cost. The issue is when, if ever, antitrust should condemn firm A for causing firm B from leaving the market.

Again, the RRC model does not require firm B to exit before attaching liability. The innovation need only raise rivals' costs sufficiently to give the innovator power over price.

Ordover and Willig recommend a two-stage test for deciding whether predatory systems rivalry exists. The first stage is the structural test outlined above, i.e. whether there are high horizontal concentration levels, entry hurdles and re-entry barriers. They say "few plaintiffs will succeed in the first stage test -

the requisite structural conditions simply do not arise very often".¹³ They state the market for the component "must exhibit very high concentration". They do not precisely define very high concentration.¹⁴

The second stage is whether the innovator undertook systems rivalry solely because of the prospect of additional monopoly profits resulting from the irreversible exit of rivals. Ordover, Sykes and Willig state:

"The issue is not whether the innovator causes the rival to exit but whether the additional monopoly profit attendant on exit was the *raison d'être* for the innovation".¹⁵

The authors identify two vital factors in deciding whether the innovation was predatory : the "compensatory price" test, and the level and type of research and development costs.

The Compensatory Price Test:

Under the Ordover and Willig model, the innovator has a defence to a systems predation claim by pricing the pre-existing component at or below its compensatory price. The authors define the compensatory price as follows:

"The compensatory price for a pre-existing component is the lowest price that would compensate the innovator for making the component available under the continued viability premise".¹⁶

If the innovator refuses to continue selling the pre-existing component or sells it only at a price greater than the compensatory price, then there may be

13 Ordover, Sykes & Willig, *supra*, note 1, at 1164.

14 *Id.* at 1152.

15 *Id.* at 1155.

16 Ordover & Willig, *supra*, note 4, at 43.

predatory profit sacrifice. That is, the innovator's decisions about the price or availability of the pre-existing component could only be rational on the basis that a rival will leave the market.

In markets which met Ordoover and Willig's first stage test, the compensatory price test imposes a duty on the innovator to sell the pre-existing component at or below the compensatory price. Ordoover and Willig suggest two formulae, which they consider equivalent for calculating the compensatory price:

1. the price of the pre-existing component that compensates the innovator for lost sales of the new system (i.e. the production cost of the pre-existing component plus the lost profit on sales of new systems) or
2. the price that yields the same mark-up on the pre-existing component as the mark-up on the new parallel component, when the latter mark-up is calculated conservatively.¹⁷

Under these approaches the compensatory price test meets an efficiency test.¹⁸ The test ensures that the new system produces greater economic surplus over its current production costs than the old system, with research and development costs for the new systems considered sunk costs that cannot be recovered. If consumers prefer the new system to the old, and this forces rivals from the market, then a greater economic surplus can be established if and only if the pre-existing component is made available at or below the compensatory price. If the component is not so available, the plaintiff has established its case.

17 Id. at 45.

18 Id. at 43-47.

Level and Type of Research and Development Costs:

A plaintiff can prevail by showing a defendant had a predatory purpose for its research and development investment in the new system. A plaintiff can show a predatory purpose if the innovator expected to recoup its research and development investment only by forcing a rival to exit and thereby earning monopoly profit. In contrast, the innovator can establish it did not have a predatory purpose by showing that it based its research and development investment on a legitimate *ex ante* expectation that the economic superiority of the new system would enable the innovator to recoup its investment.

Ordover and Willig's research and development test has three elements.

1. The test only considers *ex ante* expectations. It ignores whether the research and development investment, in fact, turned out to pay for itself.
2. The test evaluates the purpose for the research and development investment, not objective evidence as in the compensatory price test.
3. The plaintiff has the burden of proof to establish the innovator's improper motive.

Plaintiffs will find this burden difficult to establish. Ordover and Willig note:

"the plaintiff would most likely need a 'smoking gun' - a document or oral admission that clearly reveals the innovator's culpable state of mind at the time of the [research and development] decision".¹⁹

19 Ordover, Sykes & Willig, *supra*, note 1 at 1158.

Critique:

Commentators have severely criticised Ordoover and Willig's model.

Professor Geoffrey Sidak writes:

"[t]he most glaring deficiency in the ... model is its cavalier treatment of the chilling effect that its proposed test would have on innovative activity".²⁰

He argues the test is unduly complex. This would necessitate costly litigation before the analytical details of the model become clear and predictable rules emerge.²¹ He argues that efforts to distinguish predatory innovation from legitimate product development are likely to encounter several difficulties.²² First, the model involves difficult after-the-fact assessments that measure product improvements against the expenditures needed to attain them. Research and development is a fundamentally risk-laden, uncertain activity. Ex post legal evaluations may give inadequate weight to the valid expectation a firm had for its research and development expenditures when it undertook them.

Second, predatory product development scenarios present circumstances where the defendant has a mix of predatory and procompetitive purposes. All innovators have the purpose of their new products causing rivals to exit, leaving the innovators with the ability to monopoly price. Courts that attempt to second guess bona fide technical judgments made under conditions of uncertainty would risk entering a slippery, error-prone terrain.

20 Sidak, Debunking Predatory Innovation, 83 COLUMB. L. REV., 1121, 1142 (1983).

21 Ibid.

22 Id. at 1164.

Other commentators, such as Professors Phillip Areeda and Herbert Hovenkamp²³ argue a firm is unlikely to use innovation as a means of predation. Research and development is hideously expensive. Firms will not engage in it without some reasonable expectation that it will result in advances in the technical state of the art.²⁴

Investments in technically empty product development work runs a number of risks. Some rivals may easily invest around the intended obstacle, rendering the technical blockage useless.²⁵ Other rivals may continue to devote all of their product development resources to achieving real technical breakthroughs. Would-be predators will realise that failing to keep pace - for example by diverting scarce resources to projects that promise no technical advances but may impede rivals - could produce damaging results where technological leadership generates market superiority. Why would a firm spend huge sums on technically empty product development when it could spend it on genuine research and development?²⁶

It is also extremely difficult and costly to stop research and development. Research and development is a long-term commitment. Predatory pricing, on

23 P. AREEDA & H. HOVENKAMP, ANTITRUST LAW SUPPLEMENT (1990).

24 Id. at 684.

25 Scherer, Antitrust, Efficiency, and Progress, 62 N.Y.U.L. REV., 998 at 1014-1015 (1987). (He discusses how peripheral equipment manufacturers did this to counter IBM's efforts to exclude them from the market).

26 Easterbrook, Comments on Ordover & Willig in STRATEGY PREDATION AND ANTITRUST ANALYSIS, 416, 417 (S. Salop ed. 1981).

the other hand, is necessarily temporary. A firm can stop it very quickly. The only lost revenue is on the low price sales. Predatory innovation incurs greater losses. All the money spent on research and development is lost for good.²⁷ The wasted research does not even send a signal that the firm is a hard competitor. It may send the opposite signal. The firm does not know what it is doing in research and development.

Judge Frank Easterbrook criticises the model as being unworkable. The model suggests that the predator's product innovation must substantially increase the likelihood of a rival exiting. Elsewhere the model speaks of innovation raises the probability of a rival exiting. Easterbrook argues the model does not establish how likely, is too likely.²⁸ Is it 20 per cent or 70 per cent? Ordover and Willig also do not suggest how a court can determine such likelihoods, if in fact, the rival survived.

Easterbrook also notes that the model will chill innovation.²⁹ Introducing a new product is a gamble. Many new products fail. Under the Ordover-Willig model an innovator faces two risks. First, the product may fail. The innovator must face losses from that failure. Second, the innovator may face a predatory innovation claim. This is likely to discourage innovation significantly. Even if the new product succeeds, the innovator faces a predatory innovation claim. Often a plaintiff will argue that an alternative innovation strategy would have caused it less harm. This will involve courts assessing

27 AREEDA & HOVENKAMP, *supra*, note 23.

28 Easterbrook, *supra*, note 25 at 441.

29 Ibid.

whether some non-existent innovation, if pursued and developed through an alternative strategy, would have better for the innovator and its rivals. This will involve Courts speculating on things they are ill-trained and ill-equipped to do. It would also give rivals the best of all possible worlds. Rivals can wait and see whether the new product succeeds. If so they can challenge the new product on the basis of hypothetical profitability of hypothetical strategies. This will discourage innovation. Indeed, it will cause firms to decrease research and development to decrease the risk of paying damages in an antitrust claim.³⁰ Proponents of dynamic efficiency would agree. They argue that technological progress is the chief source of consumer welfare.³¹ Thus, anything that lessens the incentive to innovate harms consumer welfare.

Easterbrook also criticises the compensatory price test. He argues it harms efficiency. Ordover and Willig say this is the price at which old model sales would be as profitable as new model sales. Yet if the new model is sufficiently superior to the old, no one will purchase old models at "compensatory prices". How can a firm sell a product no one wants?³²

Former Judge and Professor, Robert Bork argues that a firm which changes its products' characteristics is not engaging in predation. He admits it may be an entry barrier - however, he regards physical product differentiation

30 Ibid.

31 See J. SCHUMPETER, *CAPITALISM, SOCIALISM AND DEMOCRACY*, 81-106 (1942); F. SCHERER, *INNOVATION AND GROWTH : SCHUMPETERIAN PERSPECTIVES* (1984); M. PORTER, *COMPETITIVE ADVANTAGE OF NATIONS* (1990); Scherer, *supra*, note 24, at 1010-1012.

32 Easterbrook, *supra*, note 25, at 446.

as a form of efficiency:

"Sellers differentiate their products physically in order to increase their appeal to customers: The differentiation may be strictly fundamental in a mechanical sense, or it may be decorative. In any case, the differentiation is profitable only if consumers respond to it favourably. For this reason physical product differentiation must, when it succeeds, be classified as a form of efficiency. But can it bar entry? Of course it can. The entrant is free, however to form his product as he wishes, and the incumbent's differentiation can make his path more difficult only if consumers prefer the incumbents version of the product".³³

The RRC cost model explains how product innovation raises rivals' costs. Yet it is useless at distinguishing predatory innovation from normal innovation. A superior new product will raise rivals' costs and it will give the innovator power over price. A predatory product innovation will do the same. One cannot infer an anticompetitive purpose from the innovator gaining power over price. The model is thus, of limited relevance except in showing how product innovation can raise rivals' costs.

The criticisms of the Ordover-Willig model are valid. U.S. Courts have been extremely reluctant to hold innovation predatory. I turn to examine the case law.

U.S. Case Law:

U.S. Courts have been extremely reluctant to impose liability for product innovation. Courts have noted the antitrust laws have a strong policy favouring

33 R. BORK, *THE ANTITRUST PARADOX : A POLICY AT WAR WITH ITSELF*, 312 (2d ed. 1993).

innovation.³⁴ They have argued antitrust should not "chill" or "stifle" innovation.³⁵ However, Courts have identified two areas of antitrust concern over innovation:

1. design change, and
2. failure to disclose new products.

1. **Design Change:**

The introduction of a new product alone is not predatory conduct alone.

The Second Circuit in Berkey Photo, Inc. v Eastman Kodak Co.³⁶ observed:

"Because ... a monopolist is permitted, and indeed encouraged, by s. 2 to compete aggressively on the merits, any success that it may achieve through "the process of invention and innovation" is clearly tolerated by the antitrust laws".³⁷

The Court also noted "any firm, even a monopolist, may bring its products to market whenever and however it chooses".³⁸ The Court, however did say this rule is not absolute. It rejected Kodak's argument that "new product introductions are ipso facto immune from antitrust scrutiny".³⁹ The Court noted

34 Berkey Photo, Inc. v Eastman Kodak Co., 603 F. 2d 263, 282 (2d Cir. 1979), cert. denied. 444 U.S. 1093 (1980); ILC Peripherals Leasing Corp. v IBM, F. Supp. 423, 433-44 (N.D. Cal. 1978) (innovations are "precisely what the antitrust laws were meant to encourage"); In re IBM Peripheral EDP Antitrust Litigation, 481 F. Supp. 965, 1003 (N.D. Cal. 1979) ("Truly new and innovative products are to be encouraged, and are an important part of the competitive process").

35 See, e.g. Berkey Photo, supra, note 2, at 282-283.

36 Supra, note 2.

37 Id. at 281 (citation omitted).

38 Ibid.

39 Id. at 286 n. 30.

that "the situation might be completely different"⁴⁰ if a firm engaged in other conduct that was related to the introduction of the new product which was not intended to benefit the firm through increased output. Here, associated conduct to the innovation made Kodak liable. The Court held Kodak breached s. 1 by extracting arguments from two rivals, Sylvania and General Electric, that the two firms would keep secret new flash cubes they were developing in separate joint ventures with Kodak. The Court held the agreements effect was to keep a "desirable innovation" off the market for an unnecessarily long time "solely to suit Kodak's convenience".⁴¹ It is extremely uncertain whether future courts will follow Berkey's reasoning. Justices Rehnquist and Powell sharply questioned its soundness in their dissent from the Supreme Courts denial of certiorari.⁴² Justice Rehnquist described the Second Circuits reasoning on the above point as "little less than bizarre".⁴³

Some cases have suggested that introducing a new product can constitute monopolisation if a less restrictive alternative is available to achieve the required goal.⁴⁴ However such comments were obiter. No court has held as such.

IBM's changes in the design of various of its peripherals led to a flood of

40 Id. at 302.

41 Ibid.

42 444 U.S. 1093 (1980).

43 Id. at 1094.

44 Transamerica Computer Co. v IBM, 698 F. 2d 1377 (9th Cir.), cert. denied, 464 U.S. 955 (1983); Northeastern Telegraph Co. v AT & T, 651 F. 2d 76, 94-96 (2d Cir. 1981), cert. denied, 455 U.S. 943 (1982).

litigation.⁴⁵ The Ninth Circuit Court of Appeals never found a breach. It held as a matter of law it was not anticompetitive for IBM to integrate into its central processing unit (CPU) certain features that it previously sold as separate products. It so held even though it prevented IBM's rivals from offering their own versions of the previously separate products.⁴⁶ It so held because of "uncontroverted" evidence that "integration was a cost-saving step" and on "substantial evidence" that "it also represented a performance improvement".⁴⁷ If such integration improves performance or reduces cost it will be lawful regardless of the resultant incompatibility with formerly interchangeable competitive parts. The Court noted in California Computer Products, Inc. v IBM Corp.:

"IBM, assuming it was a monopolist, had the right to redesign its products to make them more attractive to buyers - whether by reason of lowering manufacturing costs and price or improved performance. It was under no duty to help CalComp or other peripheral equipment manufacturers survive or expand. IBM need not have provided its rivals with disk products to examine or copy ... nor have constricted its product development so as to facilitate sales of rival products".⁴⁸

45 California Computer Products, Inc. v IBM Corp., 613 F. 2d 727 (9th Cir. 1979); In re IBM Peripheral EDP Devices Antitrust Litigation, 481 F. Supp. 965, 1002-1008 (N.D. Cal. 1979), aff'd sub. nom. Transamerica Computer Corp. v IBM Corp. 698 F. 2d 1377 (9th Cir.), cert. denied, 464 U.S. 955 (1983); ILC Peripherals Leasing Corp. v IBM Corp., 458 F. Supp. 423 (N.D. Cal. 1978), aff'd sub nom. Memorex Corp. v IBM Corp., 636 F. 2d 1188 (9th Cir. 1980), cert. denied, 452 U.S. 972 (1981).

46 California Computer, supra, note 44, at 743-744.

47 Id. at 744.

48 Id. at 744 (citations omitted).

In In re IBM Peripheral EDP Devices Antitrust Litigation⁴⁹ the District Court upheld one of IBM's interface changes despite holding IBM adopted it principally to preclude competition. The Court set out the following test for design changes:

"If the design change is unreasonably restrictive of competition, the monopolist's conduct violates the Sherman Act. This stand will allow the factfinder to consider the effects of the design on competitors; the effects of the design on consumers; the degree to which the design was the product of desirable technological creativity; and the monopolist's intent, since a contemporaneous evaluation by the action should be helpful to the factfinder in determining the effects of a technological change".⁵⁰

As mentioned above, the Court found IBM changed one of its interfaces predominantly to preclude or delay competition and to gain a competitive advantage. It, however, also found the new interface design was "superior" to existing designs and had a "negligible" effect on IBM's rivals. It thus found no liability. It held to do so would be to condemn IBM for its intent alone.⁵¹

The District Court in Transamerica Computer,⁵² following IMB Peripheral, also suggested that creating deliberate incompatibility to injure rivals without enhancing performance or reducing cost would be illegal.⁵³ Again, this comment was obiter.

49 Supra, note 44, 481 F. Supp. 965.

50 Id. at 1003.

51 Id. at 1005.

52 Supra, note 44.

53 Id. at 1383.

Predisclosure:

U.S. Courts have held a monopolist does not have to notify its rivals that it intends to introduce a new product into the market or to provide its rivals with technical information about the new product. In Berkey,⁵⁴ the plaintiff argued Kodak's monopoly of the camera market meant it had to predisclose to rival camera manufacturers the specifications of its new camera to enable them to modify their cameras to be compatible with the new film when Kodak introduced the new camera. The Court disagreed. It explained that an effective predisclosure rule that would give business managers adequate guidance and protect their incentives to innovate would be difficult, if not impossible to craft. It noted:

"If a firm that has engaged in the risks and expenses of research and development were required in all the circumstances to share with its rivals the benefits of those endeavours this incentive would very likely be vitiated".⁵⁵

Although the Court held Kodak did not breach s. 2 by failing to disclose, it held it breached s. 1. Kodak had entered into a joint venture agreement with two of its rivals. As it had disclosed to these rivals the Court held it should have disclosed to its other rivals. The agreements breached s. 1. As mentioned above, Justices Rehnquist severely criticised this part of the decision.⁵⁶ He wrote:

54 Supra, note 2.

55 Id. at 281, see also GAF Corp. v Eastman Kodak Co., 519 F. Supp. 1203, 1228 (S.D.N.Y. 1981) ("only in the rarest cases will a monopolist's failure to disclose technical information concerning its new product support a claim for treble damages under s. 2").

56 Supra, note 44.

"If the Sherman Act requires "predisclosure" by one competitor to another before a new product can be marketed, I think that the raised eyebrows resulting from such a holding should come from this Court, and not from extrapolations by other federal courts of the decisions of this court interpreting the Sherman Act".⁵⁷

The computer cases also held a monopolist does not breach s. 2 by failing to disclose.⁵⁸ A monopolist can enjoy the "lead time" achieved when it does not predisclose a new product and thus sells in the market for some time with virtually no competition.⁵⁹ The District Court in ILC Peripherals Leasing Co. held this lead time was one of the primary incentives to innovate.⁶⁰ Thus, courts should not condemn it.

Ssection 36 and Product Innovation:

If New Zealand courts were to allow a predatory product case, it is likely they would adopt the reasoning in In re IBM Peripheral EDP Devices Antitrust Litigation.⁶¹ If a product change was a superior design or reduced cost, the firm introducing it would not have used its dominant position. Making a change to reduce costs or improve performance is possible in a competitive market. If, as in Transamerica Computer,⁶² a dominant firm made the change to injure rivals without enhancing performance or reducing costs, the use element would

57 Id. at 1094.

58 See supra, note 44.

59 Berkey, supra, note 2, at 279-283; ILC Peripherals Leasing Corp., supra note 44, 458 F. Supp. at 437.

60 ILC, *ibid.*

61 Supra, note 49.

62 Supra, note 44.

be met. Only a dominant firm could afford to do so. It would only be rational for a dominant firm to do so. The purpose limb would be met here.

It is likely New Zealand courts would decide the predisclosure and product introduction cases the same way also. Firms in competitive markets are capable of not disclosing and introducing new products. Thus, there would be no "use" of a dominant position.

Conclusion:

Predatory product innovation is a possible economic theory. However, strong policy arguments suggest courts should not hold it to be an antitrust violation. To do so would be to discourage innovation. The RRC model while showing innovation can raise rivals' costs and give the innovator power over price is useless in distinguishing predatory innovation and competitive innovation. Successful competitive innovation will raise rivals' costs and give the innovator power over price. If a New Zealand court ever heard a predatory innovation case, the RRC model would not help.

CHAPTER X

PREDATORY HIRING

Introduction:

Hiring a key employee away from a rival can be an effective anticompetitive strategy. It can deprive a firm of the employee's expertise. This expertise may be crucial to the firm's continued existence. It can set back a firm's plans. The U.S. Supreme Court recognised in Hitchman Coal & Coke Co. v Mitchell,¹ that by hiring away key employees of a rival, a firm can alter an industry's structure and unfairly affect competition.² In the case of a new entrant it can delay it from acting competitively. The firm may not only have to hire someone new, but also re-train him or her. It may also raise rivals' costs. The firm may have to hire someone of similar expertise. This will likely be expensive, depending on the position in the firm. Merely bidding for a rival's key employee can raise rivals' costs. The rival will have to pay the employee more to keep him or her. It can also give the hiring firm power over price. Commentators have recognised dominant firms can use hiring as a predatory

1 245 U.S. 229 (1917).

2 See *id.* at 259. "Certainly, if a competing trader should endeavour to draw custom from his rival, not by offering better or cheaper goods, employing more competent salesmen, or displaying more attractive advertisements, but by persuading the rivals' clerks to desert him under circumstances rendering it difficult or embarrassing for him to fill their places, any court of equity would grant an injunction to restrain this as unfair competition".

strategy.³ Professors Phillip Areeda and Donald Turner have written:

"Unlawful predatory hiring occurs when talent is acquired not for the purposes of using that talent but for purposes of denying it to a competitor. Such cases can be proved by showing that the hiring was made with predatory intent, i.e. to harm competition without helping the monopolist, or by showing a clear non-use in fact. Absent either of these circumstances ... employment should not be held exclusionary".⁴

The problem with predatory hiring, as with all predation, is to distinguish it from normal competition. Firms hire and make offers to rivals' employees as a matter of everyday business life. Head-hunting is normal business behaviour. U.S. courts used to hold that hiring a rivals' key employee could never breach the antitrust laws.⁵ Recently, the Ninth Circuit Court of Appeals held it could.⁶ The Ninth Circuit also established guidelines for determining whether hiring is predatory. Part II of this chapter discusses the case and its proffered guidelines. Part III criticises the guidelines and offers new ones, based in part on the RRC model. Part IV briefly discusses whether hiring could breach s. 36. Part V offers some conclusions.

3 D'Arpino, Universal Analytics, Inc. v MacNeal-Schwendler Corp. ; Predators by Hire, 60 FORD. L. REV., 335 (1991).

4 P. AREEDA & D. TURNER, ANTITRUST LAW, 2c (1978).

5 Adjuster Replace-A-Car, Inc. v Agency Rent-A-Car, Inc., 735 F. 2d 884, 894 (5th Cir. 1984), cert. denied, 469 U.S. 1160 (1985); Associated Radio Service Co. v Page Airways, Inc., 624 F. 2d 1342, 1354 (5th Cir. 1980), cert. denied, 450 U.S. 1030 (1981); Hitchman, supra, note 1 was not an antitrust case.

6 Universal Analytics, Inc. v MacNeal-Schwendler Corp., 914 F. 2d 1256 (9th Cir. 1990).

Universal Analytics, Inc. v MacNeal-Schwendler Corp.⁷

In this case, a U.S. court, for the first time, suggested hiring could breach s. 2 of the Sherman Act. Universal and MacNeal were both computer manufacturers. Both were involved in producing and developing NASTRAN. This was a computer software programme used in the aerospace industry. MacNeal had 90 per cent of the market. Universal had five per cent.⁸ It was MacNeal's main rival. Over a 15 month period, five of Universal's NASTRAN technicians left and went to work for MacNeal. Universal sued alleging MacNeal breached s. 2 by attempting to obtain and/or maintain a monopoly in the NASTRAN market. Universal claimed the five technicians leaving had a detrimental effect on its ability to further develop its version of NASTRAN and to compete effectively with MacNeal.⁹

The District Court granted MacNeal's summary judgment motion. It noted most Universal's employees who left were dissatisfied working there. MacNeal also placed the employees in NASTRAN related jobs.¹⁰

The Ninth Circuit, on appeal, held predatory hiring could breach s. 2. It defined predatory hiring by quoting Areeda and Turner's description of it.¹¹ The Court held a plaintiff, to establish a breach, had to show clearly that the

7 Id.

8 Id. at 1257.

9 Ibid.

10 See Universal Analytics, Inc. v MacNeal-Schwendler Corp., 707 F. supp. 1170, 1176-1182 (C.D. Cal. 1989).

11 Supra, note 6, at 1258.

predator intended to deny a rival talented employees. A court should find a breach only if a monopolist subjectively intended to hire preclusively or it did not use the employees in their areas of expertise once it had hired them.¹²

Universal claimed it established MacNeal's subjective intent on the basis of a MacNeal interoffice memo which stated the new employees would "wound" Universal's business.¹³ The Ninth Circuit disagreed. It held the memo did not show predatory intent. Invoking Aspen Skiing Co. v Aspen Highlands Skiing Corp's¹⁴ legitimate business purpose test, the Court held the memo did not show predatory intent. The memo did not undermine MacNeal's "legitimate business reasons for hiring much needed and competent computer programmers".¹⁵ The Court held a defendant, in a predatory hiring case, could meet Aspen's legitimate business purpose test by showing it put the employees to some use in their new firm.¹⁶

While the Court held MacNeal did not breach s. 2 it expressly endorsed future claims based on predatory hiring. However, with respect, the Ninth Circuit's test for identifying predatory hiring raises problems. The test says that hiring is only predatory if:

1. the predator had predatory intent when hiring, or

12 Ibid.

13 Id. at 1258-1259.

14 472 U.S. 585 (1985).

15 Supra, note 6, at 1259.

16 Ibid.

2. there was "clear non-use in fact".¹⁷

This, with respect, does not clearly distinguish predatory hiring and normal hiring.

The second limb of the test is unsatisfactory. Areeda and Turner, whom the Ninth Circuit followed, define this as the hiring of an employee and not putting that employee to any use.¹⁸ The only purpose of hiring is to deprive a rival of that employee's skills. This is a blatant antitrust violation. However, it will rarely, if ever, occur. Few firms will hire some one and not make use of him or her. Even putting an employee to some marginal use would satisfy the Ninth Circuit's test. It is extremely unlikely a plaintiff would ever succeed under this limb of the test. It will not stop, or even deter predatory hiring.

The subjective intent test raises the same objection. It will be difficult to establish. It requires searching through a defendant's records to find some incriminating document - a "smoking gun". Requiring objective intent would be better. The RRC model can help establish this.

Suggested test:

Any test should incorporate the RRC model. In a predatory hiring case, the input market would be qualified personnel in the particular market. If numerous qualified personnel are available, hiring one from a rival will not cause the rival any harm. It can easily hire another from the available pool. This also means that hiring would not raise rivals' costs.

17 Id. at 1258-1259.

18 AREEDA & TURNER, *supra*, note 4.

Another factor courts should take into account is how long it takes to train an employee. If few qualified people exist and the requisite training period is long and costly, hiring an employee from a rival is likely to harm competition. It is also more likely to raise rivals' costs.

A relevant factor, is the salary structure and profit margins of the predator and industry. If a predator hires a rival's employee by offering a huge salary, which is not consistent with the industry norm, it is likely the alleged predator will have an anticompetitive intent. Similarly, if the predator has low profit margins and jeopardises them by paying a huge salary to a new employee, it is more likely the alleged predator has an anticompetitive intent.

Another relevant factor is the alleged predator's past history. Courts should examine how it has hired in the past. Is the hiring of a rival's employee consistent with its past record? Has the alleged predator always employed trained personnel or conducted its own training? If it has done its own training, hiring of a rival's employee is more likely to be predatory. Similarly, past staff size will help identify whether a new hiring is excessive.¹⁹

The non-use test is relevant. However, it should not be so high. It is more likely a hiring will be predatory, if the new employee does something which does not befit his or her expertise or his or her salary.

None of these factors will be determinative. They all aid in deciding whether a hiring has been predatory. An employee may leave because he or she

19 . This is similar to the reasoning Joskow & Klevorick employ in determining whether recoupment is possible in a predatory pricing case, Joskow & Klevorick, A Framework for Analysing Predatory Pricing Policy, 89 YALE L. J., 213 (1979).

is dissatisfied with his or her current job. No liability should occur here. Similarly, an employee may initiate discussions with the alleged predator. It will be difficult to say the alleged predator had an anticompetitive purpose here. A firm may hire in the hope business will expand. Thus, apparent excess staffing is not determinative. A firm's key employees may be about to retire. Hiring a rival's employee is unobjectionable in those circumstances.

If the hiring does not give the predator power over price, courts should not condemn the hiring. Consumers will not have suffered any harm because of the hiring. Antitrust should not intervene.

Section 36:

Section 36 is capable of condemning predatory hiring. Hiring a rival's employee, when a dominant firm has no need for him or her is conduct which only a dominant firm can do. It would not do so in a competitive market. Thus, it would be a use of a dominant position. A court would consider all the factors I mentioned in the previous section, under the purpose limb.

The RRC model aids analysis. If the hiring does not raise rivals' costs courts should dismiss the claim. It will not raise costs if qualified people are plentiful. Hiring a rival's employee in such circumstances may inconvenience the rival but it will not disadvantage or deter it. If the hiring gives the dominant firm power over price courts could infer an anticompetitive purpose. However, gaining power over price should not be determinative. The hiring could be to replace a retiring employee. If so, a firm could do that in a competitive market. Thus, the "use" element would not be met. Similarly, it is unlikely the dominant

firm would have a substantial anticompetitive purpose in hiring a rival's employee in such circumstances. Although Universal's non-use test should mean a breach of s. 36, for the reasons mentioned above, New Zealand courts should not insist upon such a strict test.

Conclusion:

Predatory hiring can and should be a breach of s. 36. The RRC model is useful in identifying whether a hiring was predatory. New Zealand courts should consider the RRC model if they ever encounter a case alleging predatory hiring.

CHAPTER XI

PREDATORY ADVERTISING

Introduction:

Commentators have regarded advertising as a way in which a firm can act strategically towards its rivals. Traditionally, they have viewed advertising as raising artificial barriers to entry. This is another way of saying raising rivals' costs. Salop and Scheffman noted that advertising by a dominant firm may raise rivals' costs, enabling the dominant firm to increase price or market share.¹ However, the idea advertising can be a predatory tactic is controversial. Chicago School scholars argue it is not.² Part II of this chapter examines the arguments for advertising being a means of predation. Part III discusses the critics' view that it is not. Part IV examines the U.S. case law. Part V discusses how a New Zealand court might deal with a predatory advertising claim. Part VI offers some conclusions.

Advertising as an Anticompetitive Strategy:

The traditional view is that advertising by a dominant firm will create

1 Salop & Scheffman, Raising Rivals' Costs, 73 AM. ECON. REV., 267, 268 (1993).

2 R. BORK, THE ANTITRUST PARADOX : A POLICY AT WAR WITH ITSELF, 314 (1978); Posner, The Chicago School of Antitrust Analysis 127 U. PA. L. REV., 925, 930 (1979).

artificial barriers to entry for rivals. No precise definition of a barrier to entry exists. Professor George Stigler defines it as "a cost of producing (at some or every rate of output) which must be borne by a firm which seeks to enter an industry but is not borne by firms already in the industry".³ Professor Joe Bain defines it as the ability of a firm to increase its prices in the long run above its minimal average costs without inducing entry.⁴ Bain's definition is wider than Stigler's. Current economic thought favours Stigler's. Bain's definition includes economies of scale. Yet these are efficiency enhancing. The U.S. Federal Trade Commission has adopted Stigler's definition.⁵

No matter what the definition, commentators regarded advertising as increasing barriers to entry. Professor Donald Turner in 1965 summed up the then prevailing attitude:

"Economies in production, research, distribution and the like will inevitably lower average costs and will tend to lower prices - thus easily qualifying as procompetitive consequences. Economies in promotional expenditures, on the other hand, present less impressive qualifications. They may not lower average costs at all, since total promotional efforts may increase, and if promotional efforts are intensified, they will raise barriers to entry whenever they increase the durability of consumer preferences for established brands. In short, promotional economies, generally speaking are not as procompetitive as other types of economies ..."⁶

The argument was that advertising could, in some instances, discourage

3 G. STIGLER, *THE ORGANISATION OF INDUSTRY*, 67 (1968).

4 J. BAIN, *INDUSTRIAL ORGANISATION*, 252 (1968).

5 10 F.T.C. 410, 485 (1985).

6 Turner, *Conglomerate Mergers and Section 7 of the Clayton Act*, 78 HARV. L.R., 1313, 1361 (1965).

entry by building up durable consumer preferences that an entrant could only break down by a very large initial investment in counter-advertising. In the 1960s, the concern over advertising was related only to mergers. A merger could lead to a large firm with a huge advertising budget. By advertising heavily the large firm could discourage entry in the way mentioned above.

The focus on advertising, as an antitrust concern, has changed. Commentators now view it as a way monopolists can act strategically so as to disadvantage rivals. Professor Michael Spence argues monopolists may invest heavily in advertising and new product introductions as an anticompetitive strategy to impede entry and expansion.⁷ Advertising can do this in a number of ways. As with capacity expansion, it can be a powerful signalling device. It signals to new entrants and existing rivals that it is committed to the industry. It gives the firm the reputation as a hard and vigorous competitor. This may deter firms entering.

Advertising may raise rivals' costs. If a monopolist starts a large and vigorous advertising campaign, rivals will have to respond. They will have to respond equally or even more. This will raise rivals' costs. The effect will be greater on new entrants who will not have "deep pockets" to finance such a campaign.

The predator will be able to finance and absorb such a campaign better than an entrant or small, existing rivals. It will have better access to capital and thus, will have "deeper pockets". Its costs in advertising will be spread over a

7 Spence, Entry, Capacity, Investment and Oligopolistic Pricing 8 BELL J. ECON., 534 (1977); Spence, Investment Strategy and Growth in a New Market, 10 BELL J. ECON. 1 (1979).

larger sales volume. Thus, it will have economies of scale in advertising. Generally, the predator will use the bigger and better advertising agencies. It is more likely to be able to afford more expensive and effective types of advertising, such as television or national campaigns. The 'raising rivals' costs model shows that if a predator gains power over price it will be able to pay for the advertising out of the revenue it saves by preventing prices from falling. Thus, Professor Phillip Areeda and Donald Turner's view that advertising is only predatory "if the additional promotional costs raise the firm's marginal or average variable cost above its price"⁸ is not necessarily correct. They base their view on their test for predatory pricing. However, unlike predatory pricing, a predator does not have to eliminate its rival under an RRC strategy. The benefits are available almost immediately. Without the advertising, prices would have fallen. With the advertising they don't fall. The predator has saved revenue with which to finance its advertising.

One can also view advertising as rent-seeking. The predator is turning most of its monopoly profit into socially wasteful costs.⁹ One can argue much advertising is socially wasteful. It is not so much "informative" as "persuasive". Advertisers try and create an image for a product. Buy a certain car or aftershave and you will be successful with women. This has nothing to do with the actual qualities of the product. It is a fantasy or a daydream. Some argue this is wasteful.

8 P. AREEDA & D. TURNER, ANTITRUST LAW, 191-192 (1978).

9 Posner, The Social Costs of Monopoly and Regulation, 83 J. POL. ECON., 801 (1975).

Critique:

Former Professor and Judge, Robert Bork argues advertising is not a barrier to entry.¹⁰ No firm, no matter how large, has a monopoly on access to advertising. Any firm, no matter how small will be able to find an advertising agency. He does not view a product's reputation as an entry barrier. A firm will have had to spend considerable amounts to establish a product's reputation as reliable, worthwhile or what not. This will include spending on advertising. It is just the same as spending on building a factory. A new firm will have to spend money on establishing its product. This will include advertising. Thus, adopting Stigler's definition of an entry barrier, he argues advertising can never be an entry barrier.

Another problem with regarding advertising as a predatory strategy, is that it is essential to vigorous rivalry. Large amounts of advertising characterises highly competitive markets. If a firm does not advertise, it will go out of existence. Many products are quality-wise indistinguishable. Consumers choose the brand of product they want, based on advertising. Cola drinks and cigarettes are examples of this. When a tobacco company introduces a new cigarette it has to accompany this with a large advertising campaign to distinguish it from rivals' cigarettes. The banning of television cigarette advertising had led to a concentration in the number of cigarette manufacturers. If Bain was correct about advertising creating entry barriers, the exact opposite should have occurred.

Other empirical studies show advertising does not create entry barriers.

10 BORK, *supra*, note 2 at 316.

Professor Lester Telser on the basis of studies he conducted, concluded:

"Increased advertising, far from signifying an obstacle to entry, is very often symptomatic of the reverse. It is the high turnover of brands and sometimes of firms that accounts for the large advertising outlays on some products".¹¹

Bain argued, without empirical testing, that advertising barriers to entry were very high in the U.S. liquor industry.¹² Professor James Fergusson, empirically tested the industry and reached the opposite conclusion.¹³ He found the market share of the four largest distillers fell, despite their waging a vigorous advertising campaign when faced with new entrants. The four firm's ratio of advertising to sales had increased markedly. Yet, new firms entered.

Professor Yale Brozen, taking account of these studies concludes advertising, far from being a barrier to entry is a means to it.¹⁴ One can argue advertising is efficient as it lowers the search costs for consumers. Thus, it makes markets more competitive.

The RRC model is also problematic. Although advertising may increase rivals' costs, it is difficult to characterise advertising as a means of strategic predation. Whenever a new firm enters, the incumbent will increase advertising. It is an essential part of competition. The model shows how advertising can harm consumer welfare by raising rivals' costs, but it cannot help in distinguishing predatory advertising from normal advertising. One cannot infer

11 Telser, Advertising and Competition, 72 J. POL. ECON., 537, 556 (1964).

12 J. BAIN, BARRIERS TO NEW COMPETITION (1956).

13 Ferguson, Advertising and Liquor, 40 J. BUSS. \$!((1967).

14 Brozen, Entry Barriers and Product Differentiation, in INDUSTRIAL CONCENTRATION : THE NEW LEARNING, 115 (1974).

a predatory purpose if the dominant firm gains power over price. Normal, competitive advertising can have this effect. Ironically forcing a new firm to increase its advertising may benefit the new firm. The advertising brings the new firm's product to the public's attention. The empirical studies show the more a new firm advertises, the more likely it will succeed.

The rent seeking objective to advertising is, with respect, ill-founded. It misunderstands the purpose of advertising. The provision of information is not its only purpose. That is its main purpose. It is not the only one. Advertising is often very simple. It often contains very little information, apart from a product's name. Its aim, in such circumstances, is to make consumers aware of the product. To make them interested enough to go to retail outlets, where the retailer can give them more detailed information. This is efficient. It is expensive to advertise. The more information advertising contains, generally the more expensive it is. Thus, it is more efficient to advertise generally about a product and then give more detail once the customer has responded to the advertising by inquiring of retailers.

Advertising also has to be repetitive. Consumers face thousands of advertisements every day. To hit home, advertising must be repetitive. It also has to be relatively simple. Consumers are relatively inattentive to advertising. Making advertisements which contain a myriad of detail will not catch consumers attention. Critics who complain advertising is socially wasteful as it is simple and repetitive miss the point. It has to be to pique consumer's interest.

Those who complain advertising is too "persuasive" and not "informative" enough are not making an economic judgment. If advertising causes consumers

to pay a higher price for a product or buy more of it at the same price, the product is worth that much more to them. The increase is economically indistinguishable from a higher price due to a product improvement. It is also extremely difficult to distinguish persuasive and informative advertising. They are usually inextricably mixed. Advertisements contain elements of both. If advertisements appeal to consumers' fantasies and daydreams - so what? Doing so, sells more of the advertiser's product and thus, is efficient. The so-called rent-seeking objection, is not an antitrust objection. It is a philosophical one. Antitrust should ignore it.

RRC proponents may claim that when faced by a new entrant, a predator may engage in excessive advertising to raise rivals' costs. The problem is what is excessive. Any dominant firm will respond to an entrant by increasing advertising. Whether the response is excessive is purely a subjective judgment. Too many variables exist to be able to find a similar market to which to compare. The problem is insurmountable.

U.S. Law:

In Berkey Photo, Inc. v Eastman Kodak Co.¹⁵ the Second Circuit Court of Appeals recognised, obiter, that a monopolist, in some circumstances, can breach s. 2 by advertising. However, it has wide latitude to advertise truthfully and aggressively. The Second Circuit stated:

"A monopolist is not forbidden to publicise its product unless the extent of this activity is so unwarranted by competitive exigencies as to constitute an entry barrier. And in its advertising, a producer

15 . 603 F. 2d 263 (2d Cir. 1979).

is ordinarily permitted, much like an advocate at law, to bathe his cause in the best light possible. Advertising that emphasises a products strengths and weaknesses does not, at least unless it amounts to deception, constitute anticompetitive conduct violative of s. 2".¹⁶

Similarly, the Fifth Circuit Court of Appeals held in Phototron Corp. v Eastman Kodak Co.¹⁷ held:

"Advertising that creates barriers to entry in a market constitutes predatory behaviour of the type the antitrust laws are designed to prevent".¹⁸

Two problems arise with these findings. First, Berkey quoted two cases as authority. American Tobacco Co. v U.S.¹⁹ and In the Matter of Borden, Inc.²⁰ Neither of these cases appear to be based on a finding the defendant's conduct was predatory. In American Tobacco the Supreme Court held the four largest cigarette manufacturers in the U.S. had monopolised the cigarette industry. The Court commented on advertising as follows:

"In each of the years 1937, 1938 and 1939 [the defendants] expended a total of over \$40,000.00 a year for advertising. Such advertising is not here criticised as a business expense. Such advertising may benefit directly the entire industry, including the competitors of the advertisers. Such tremendous advertising, however, is also a widely publicised warning that these companies possess and know how to use a powerful offensive and defensive weapon against new competition. New competition dare not enter such a field, unless it will be well supported by comparable

16 Id. at 287-288 (citations omitted).

17 842 F. 2d 95 (5th Cir. 1986), cert. denied, 486 U.S. 1023 (1988).

18 Id. at 100-101.

19 328 U.S. 781 (1946).

20 92 F.T.C. 669 (1978), aff'd, 674 F. 2d 498 (6th Cir. 1982), vacated and remanded, 461 U.S. 940 (1983).

national advertising".²¹

The Court does not seem to have based its decision on the defendant's alleged predatory advertising. The Federal Trade Commission's Borden finding, that the respondent monopolised the reconstituted lemon juice market is also unclear authority for Berkey holding advertising is predatory. In Borden, the F.T.C. held Borden enjoyed substantial market power based on the "dominant brand name" of its product Rea Lemon. Faced with competition from other lemon juice manufacturers, Borden started advertising heavily, offering promotional allowances and price cutting. In some areas its prices were below average total cost. As the Rea Lemon name allowed Borden to price substantially above its rivals, Borden's price cuts forced its rivals to lower their prices below their average variable costs. Neither the F.T.C. nor the Sixth Circuit make it clear whether Borden's conduct would have been exclusionary without the pricing issues.²²

Second, the Phototron case and Berkey make it clear that if a monopolist advertises falsely, then it will breach s. 2. Such conduct would not breach s. 36 of the Commerce Act. It breaches the Fair Trading Act 1986 in New Zealand. The U.S. cases on advertising deal with the content of the alleged predator's advertising. If it is false or involved passing off it breaches s. 2.²³ No court has held truthful advertising breaches s. 2. Plaintiffs have claimed defendants

21 Supra, note 19, at 797.

22 Supra, note 20, F. 2d at 517-521.

23 See, e.g. Hunt-Wesson Foods, Inc. v Ragu Foods, Inc. 627 F. 2d 919 (9th Cir. 1980).

breached s. 2 by heavily promoting a new product long before it introduced it.²⁴ As long as the advertising was truthful, U.S. courts have permitted it. Indeed Berkey suggests it never will breach s. 2. Consequently, the U.S. law is irrelevant to New Zealand. I shall not consider it.

Section 36:

It is unlikely a New Zealand court would find advertising could breach s. 36. Increasing advertising in response to a new entrant is part of normal competition. It is essential to it. A firm could and would do so in a competitive market. Thus, it would not be a use of a dominant position. Possibly one could argue that the advertising was excessive and only a dominant firm could do so. However, the intractable problem of determining what is excessive remains.

The RRC model, while showing advertising increases costs for rivals, cannot distinguish between predatory and normal advertising. Thus, it would be of no use to a New Zealand court.

The U.S. decisions on false advertising breaching s. 2 are irrelevant to s. 36. False advertising breaches the Fair Trading Act. New Zealand courts would not consider such cases under s. 36. Even the smallest firm can falsely advertise. Thus, it would not be a use of a dominant position.

Conclusion:

The RRC model can show how advertising can raise rivals' costs and give

²⁴ Berkey, supra, note 15; GAF Corp. v Eastman Kodak Co. 519 F. Supp. 1203 (S.D.N.Y. 1981).

the advertiser power over price. However, competitive advertising can have this effect. The model cannot distinguish between predatory and competitive advertising. There are strong reasons for holding advertising cannot breach s. 36. Courts should not use the RRC analysis to hold that advertising can breach s. 36.

CHAPTER XII

ABUSE OF JUDICIAL AND ADMINISTRATIVE PROCESSES

Introduction:

Abusing judicial and administrative processes is a paradigm raising rivals' costs strategy. It does not fall into any of Krattenmaker and Salop's four scenarios. However, it may give the predator power over price. It merits antitrust concern.

In 1978, former Judge and Professor, Robert Bork alerted the antitrust community to the dangers of abuse of governmental processes,¹ including judicial and administrative processes. This involves a dominant firm using judicial and administrative processes as an anticompetitive weapon. A dominant firm can do this in a number of ways. For example, it can make planning objections to delay a rival's entry into the market. It can bring litigation against a rival - not in the hope of winning but to increase its rival's costs. As Bork notes, the enormous proliferation of regulatory and licensing authorities at every level of government "offers almost limitless possibilities for abuse".² Microeconomic reform has ushered in competition in previously monopolised markets in New Zealand. Litigation is a way established forms may try to stifle

1 BORK, *THE ANTITRUST PARADOX : A POLICY AT WAR WITH ITSELF* ch. 18 (1978), (2d 1993).

2 *Id.* at 347.

competition. Williams J., in Telecom Directories Ltd v Ad Viser (NZ) Ltd,³ commented on this in the context of comparative advertising:

"The vigorous promotional campaign of the obstreperous newcomer involved the fashionable marketing technique of comparative advertising. The mature monopolist, as is now almost obligatory in such situations in recently deregulated markets in New Zealand, cried foul. It claimed that the advertising material was misleading. ... With alacrity it commenced proceedings and sought an interlocutory injunction. The established ritual was concluded in the customary way with the new entrant proclaiming loudly ... that the proceedings by the monopolist had nothing to do with protection of consumers from deception but were instead motivated by a powerful urge to stifle incipient competition."

In the last 18 months there has been litigation alleging such abuse in New Zealand, Australia and Canada. This shows that the issue could emerge as a very important one. Judicial reaction has spanned the spectrum: from scepticism by Smellie J. in the New Zealand High Court in Telecom v Clear Communications,⁴ to a cautious treatment by Olney J. in the Federal Court of Australia in Cadbury Schweppes v Kenman,⁵ to a willingness to explore the issue by Barker J. in the High Court and the New Zealand Court of Appeal in Electricity Corp Ltd v Geotherm Energy Ltd,⁶ to a warm embrace by the Canadian Competition Tribunal in Director of Investigation and Research v Laidlaw.⁷

This chapter discusses the law from a comparative perspective. Part II

3 Unreported, HC, Auckland, CP 1216/92 at 1; Williams J. did not discuss whether Telecom breached s. 36 by seeking an interim injunction.

4 [1992] 3 NZLR 247.

5 (1991) ATPR para 41-116.

6 [1992] 2 NZLR 641.

7 (1992) 40 CPR [3d] 289 (Competition Trib.).

examines why abuse of judicial and administrative processes (abuse of process) is an attractive predatory practice. Part III discusses the New Zealand, Australian and Canadian case-law and Part IV explores the American law which is interlinked with the important judicially created Noerr-Pennington doctrine. Part V seeks to identify the issues that are likely to arise in predatory litigation and suggests ways in which New Zealand courts might treat them under s. 36. Part VI offers some conclusions.

Attractions as an Anticompetitive Strategy:

Abuse of processes can be an effective anticompetitive strategy.⁸ It can raise rivals' costs. A firm can tie a competitor up in expensive proceedings. The parties usually face equal costs although a plaintiff can arrange things so that the defendant has to pay more;⁹ for example, a plaintiff may persuade a government body, such as an enforcement agency, to intervene and thus, avoid costs altogether. It may be cheaper to bring an action than to defend it. A plaintiff may make a defendant undertake expensive discovery. The consequences of losing are likely to be greater for a defendant, so he or she may

8 For further discussion on the effectiveness of the strategy, see Hurwitz, Abuse of Governmental Processes, the First Amendment and the Boundaries of Noerr, 74 GEO. L. J., 65, 68-76 (1985); Myers, Predatory Litigation, 80 KEN. L. J. 566, 577-607 (1292). Balmer, Sham Litigation and the Antitrust Laws, 29 BUFFALO L. REV., 39, 62-64 (1980); Klein, Strategic Sham Litigation : Economic Incentives in the Context of the Case Law, 6 International Review of Law and Economics, 241 (1986); Klein, Predation in the Courts : Legal versus Economic Analysis in Sham Litigation Cases, 10 International Review of Law and Economics, 10 (1990).

9 BORK, *supra*, note 1, at 348.

feel compelled to spend a disproportionate amount in her or his defence. The tactic is especially effective against a small firm. The costs of defending an action are relatively independent of a defendant's size - thus, the costs will be proportionately higher for a small firm.

The tactic is particularly effective against potential market entrants. A market entrant probably requires some regulatory approval; for example, planning permission. Thus, a firm has considerable scope for objecting and possibly delaying entry. Well-timed litigation can divert managerial time from developing business plans into developing litigation strategy. New entrants generally have less capital and so are more vulnerable to cost increases. Pending or actual litigation may discourage banks or investors from lending. It may force other firms to abandon joint ventures.

Apart from raising rivals' costs, predatory litigation offers other benefits for the predator. Discovery may turn up useful information. Litigation can tarnish a competitor's reputation, especially if the complaint alleges a breach of consumer protection legislation. It may impair customer relations.

Litigation may be cheaper than price predation. Its effectiveness does not depend on eliminating a competitor. By delaying entry a dominant firm can still collect monopoly profits. As Bork notes, it may well be worth the costs of litigation for an extra few years' monopoly profits.¹⁰

Litigation creates few legal risks. Few people are aware of it as a possible breach of the Commerce Act. The "action" occurs in planning tribunals and licensing authorities and often involves small businesses. These small-

10 Ibid.

business people are probably unaware of the Commerce Act's potential protection. Even alleging a violation may be risky. The law in New Zealand is in its infancy, if not its foetal stage. Alleging a breach is likely to result in applications to strike out and a dominant firm will likely appeal any adverse decisions. Thus, a small firm will incur the litigation costs it is seeking to avoid.

The strategy is likely to give the litigating firm the reputation as a hard competitor. Some commentators believe that a firm's reputation for predatory behaviour can be an effective entry barrier.¹¹ Such a reputation may deter a potential competitor from entering the market. The prospect of long, expensive litigation may overwhelm a potential entrant. As Hurwitz suggests, a firm's past successes in litigating or objecting may establish a chilling precedent.¹² A firm does not even have to succeed to achieve a deterring reputation.

Of course, from society's point of view, abusive litigation has societal detriments. It leads to deadweight welfare losses which may retard innovation. This leads to increased prices. If the dominant firm prevents entry, it thwarts competition. Thus, competition law should stop such abuse. It is necessary to examine whether s. 36 covers it. However, one must be careful. As a matter of principle, courts should interpret s. 36 to forbid a dominant firm abusing litigation so as to suppress competition. Courts should not, however, interpret s. 36 to make dominant firms outlaws, forbidden to enforce their legal rights.

11 R. POSNER, *ANTITRUST LAW: AN ECONOMIC PERSPECTIVE* 184-87 (1976); F. SCHERER, *INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE* 559-60 (2d ed. 1980).

12 Hurwitz, *supra*, note, 8 at 74.

An example¹³ may illustrate the problem. A wants to build a shopping mall. Before it can do so, the proposed location must be re-zoned. B, a dominant firm in the shopping mall market, files various objections in an attempt to delay A constructing its mall. A successfully overcomes each of B's objections. Its victories are Pyrrhic as they exhaust its financial resources, forcing it to abandon the project. If B's objections were valid it should not breach ss. 46 and 36. A dominant firm must be able to object. However, there will be circumstances in which B's conduct should breach s. 36. This chapter attempts to identify those circumstances.

Commonwealth Case-law:

New Zealand:

To breach s. 36 a dominant firm must use its dominant position for the purpose of restricting entry into a market, deterring competitive conduct in a market or eliminating a person from a market. Whether a dominant firm has breached s. 36 by abusing judicial and administrative processes depends on whether such abuse is use of a dominant position and whether the firm has the requisite purpose.

The first New Zealand case was Electricity Corp Ltd v Geotherm Energy Ltd.¹⁴ Geotherm, an intending producer of electricity in the central North Island, claimed that Electricorp (which was allegedly dominant in that market)

13 This hypothetical is derived from Landmarks Holding Corp. v Bermant, 664 F. 2d 891 (2d Cir. 1981).

14 Unreported 4/10/91 CA 169/91, Barker J.

had breached s. 36¹⁵ by (inter alia):

- (1) making public statements calculated to deter customers, financiers and investors from dealing with its competitors;
- (2) objecting to Geotherm's statutory applications at every opportunity and on all possible grounds (Geotherm alleged many of Electricorp's applications were baseless and that Electricorp had led perjured evidence and had assisted other objectors); and
- (3) entering into contracts with electrical supply authorities which prevented competition for electrical supplies.

In essence, Geotherm claimed that Electricorp had a policy to exclude all competitors.

Electricorp sought to strike out the Statement of Claim. it was unsuccessful before Barker J. in the High Court.¹⁶ The case went to the Court of Appeal. Both parties agreed that the pricing contracts could be a breach of s. 36.¹⁷ The Court of Appeal would have been happy to have left the Statement of Claim because the public statements and objections etc were relevant in ascertaining Electricorp's purpose.¹⁸ However, the Court also considered whether such conduct could amount to "use" of Electricorp's dominant position.

The Court clarified the "use that position" element of s. 36. Earlier

15 . Id. at 3 and 5.

16 Id.

17 [1992] 2 NZLR 641.

18 Ibid.

authority was split as to whether it was a separate element which a plaintiff had to prove.¹⁹ The Court confirmed that it was analytically separate from the "purpose" element and that a plaintiff had to prove both.

"The conduct prohibited by the section is the use of the dominant market position for the proscribed purposes. There will be circumstances in which the use of the market position and the purpose are not easily separated but the two requirements must be kept in mind".²⁰

The Court held that "to use" that dominant position would be actually to exercise or attempt to exercise a dominant influence over production, acquisition, supply and price of goods or services in the relevant market. "That ... may be done directly or indirectly in many ways ... and the effects or potential effects of particular conduct will be determined only on a close assessment of the market".²¹

The Court looked to s. 46 of the Trade Practices Act and held that it may not be directly comparable.

"[W]e are not satisfied that use of a market position necessarily is the same as use of market power. It is arguable that 'use of a dominant position' is to be construed as use of the market power flowing from that position. But equally a position in which unconstrained discretionary conduct is open may be 'used' without engaging in that conduct - as by threatening to do so".²²

Use of that position is not confined to market activity in the production,

19 Contrast New Zealand Magic Millions Ltd v Wrightson Bloodstock Ltd [1990] 1 NZLR 731 with Union Shipping NZ Ltd v Port Nelson Ltd [1990] 2 NZLR 662.

20 Supra, note 17, at 646-647.

21 Id. at 648.

22 Id. at 649.

acquisition, supply and price of goods and services. It extends to conduct capable of influencing those market elements.²³ There must, however, be a clear and direct link between the influence and the dominant position. Finally, the Court quoted from Hampton:²⁴

" 'Although s. 3(8)(a)-(c) contains a non-exhaustive list of factors that aid in market-power analysis, one must bear in mind that the concept of market power employed in s. 3(8) extends beyond the narrow economic notion, viz the ability of a firm to profitably raise price above marginal cost. The s. 3(8) test is whether a firm "is in a position to exercise a dominant influence over the production, acquisition, supply or price of goods or services" in a market. This expansive notion of market power would embrace rights, powers or advantages that enable the firm to exercise a major influence over one or more of the market variables mentioned. Assuming such rights et cetera contribute to the firm's dominance, then taking advantage of such rights will involve the "use" of the firm's dominant position".²⁵

The Court's overall approach indorses the view that s. 36 covers conduct which only a dominant firm could perform. Having set out its views on the constituent elements of s. 36 the Court considered each allegation separately.

Statements of Policy:

Electricorp had apparently made public statements that it had a policy to retain its virtual monopoly and that it intended to take steps to deter potential competitors and customers. Electricorp allegedly said it would lower its charges in order to meet any competition. The Court held that such statements could

23 Ibid.

24 Hampton, Section 36(1) of the Commerce Act 1986: An Analysis of its Constituent Elements in COMPETITION LAW AND POLICY IN NEW ZEALAND 179, 185 (Ahdar ed. 1991).

25 Supra, note 17, at 650.

breach s. 36 and whether they did in this case had to be determined on the evidence. It noted:

"We are not satisfied that statements made on behalf of a company in a dominant position as to the intended exercise of market power to deter potential competitors, made in circumstances that make them in fact likely to deter competition, could not fall within s. 36. Such statements may be said to 'use' a dominant position if it is the dominant position that gives the statements the force amounting to deterrence".²⁶

With respect, this seems to be correct. Such statements could deter competitors and customers. A firm's dominance gives these statements serious force. Its economic resources ensure it will be able to back up its policy effectively. Such statements could deter investment. One can extend this reasoning to threats of litigation. This too, could discourage investment. Again, dominance gives the threats serious force. The statements will have extra deterrence if the dominant firm has a reputation for successfully preventing firms from competing with it. They may also raise the potential entrant's costs as it is likely to seek legal advice in evaluating the threats. A non-dominant firm is unlikely to have such a reputation and be able to afford to back up the statements as effectively.²⁷

26 Id. at 650.

27 An example of the effectiveness of a dominant firm's threats to litigate is CVD v Raytheon Co., 769 F. 2d 842 (1st Cir. 1985). Raytheon threatened to bring a breach of trade secrets case against some former employees and their newly formed corporation. The case had no substance. The employees knew this. Despite this they granted Raytheon a licensing agreement. The Court noted:

"Raytheon did not actually initiate litigation against the plaintiffs. Instead, the evidence indicated that it used the threat of litigation to exact a licensing agreement from the plaintiffs. In this case, litigation

Statutory Approvals:

Electricorp argued that exercising statutory rights of objection can never breach s. 36. Geotherm said it objected to the way Electricorp exercised these rights, namely, the alleged perjury, overreaching grounds of opposition and assisting other objectors. The Court rejected Electricorp's contentions and was not prepared to say that exercising statutory rights could not be a use of s. 36. It said "it can be argued with some strength that the exercise of statutory rights will not necessarily be beyond the scope of the New Zealand s. 36".²⁸ The Court noted that if

"technical knowledge and access to materials and capital [factors which indicate whether a firm can influence price, acquisition, production and supply and thus have a dominant position in the market] ... are an element of a dominant position and are used in the course of the exercise of statutory rights for a proscribed purpose s. 36 might be breached".²⁹

Again, with respect, this appears to be correct. As mentioned above, the purpose of predatory litigation is to increase costs and to delay or prevent entry. Achieving this can influence price, acquisition, production and supply of goods and services.

The Court did not think that exercise of reasonable rights of objection could contravene s. 36.

"[A] monopoly [is] entitled to make a case to the appropriate licensing or other authority for the preservation of its monopoly.

with Raytheon would have proved ruinous to the newly formed corporation, and effectively foreclosed competition in the relevant market".

28 *Supra*, note 17, at 651.

29 *Ibid.*

The submission of reasonable arguments to that end and the taking of reasonable steps to prepare the case could not in themselves amount to use of a dominant position in the market. Something more would have to be shown to bring Electricorp's [a dominant firm's] conduct within s. 36".³⁰

The Court could not discount that possibility so it refused to strike out the Statement of Claim.

It is necessary to examine what factors led the Court of Appeal to conclude this. Geotherm alleged the following:

- (i) The statutory objections were part of a larger anti-competitive scheme.
- (ii) Electricorp had committed perjury and made misrepresentations during the hearings of the statutory objections.
- (iii) Electricorp had assisted other objectors.
- (iv) Electricorp's objections were in many cases baseless.
- (v) Electricorp objected at every stage on all possible grounds.

This was the "something more" the Court of Appeal referred to.

A nondominant firm can make reasonable arguments and take reasonable steps in preparing a case. "Reasonable arguments" suggests that the firm making them wants to or, at least, has a chance to win. A firm that makes unreasonable arguments cannot win. A firm in a competitive market could not afford to waste money on a case it could not win. Similarly, it would not be able to afford to object regardless of the merits or afford to assist other objectors. A dominant firm that has made monopoly profits could afford to do so. It has "deep pockets". In this way a dominant firm uses its position. The above factors are also relevant to purpose. A firm which brings a case it cannot win must have a

30 Id. at 655.

purpose other than winning. This must be to harm the other party.

The Court, following Barker J., rejected Electricorp's argument that allowing the objections to be a breach of s. 36 would mean re-litigating all the statutory applications. The Court quoted Barker J.:

" I see no justification for holding that the plaintiffs' surviving allegations disclose no reasonable cause of action or are an abuse of the process of the Court, even though there may be, of necessity, some consideration of earlier litigation before various tribunals. I stress that this Court will not relitigate the merits of these applications but will merely assess the conduct of the first defendant; e.g. investigate whether either it procured false evidence, paid persons to object or made unnecessary objections with the purpose of exercising dominant market power".³¹

The case leaves many questions unanswered. The Court considered a list of allegations which may be a breach of s. 36.³² It is unlikely that this list is exhaustive. While the Court talked of reasonable objections and preparatory steps it did not say whether reasonableness is objective or subjective. The Court also raised the possibility that the Bill of Rights Act 1990 might affect s. 36. It did not consider how.

To date the only other New Zealand case involving predatory litigation is Telecom v Clear Communications.³³ Clear alleged that Telecom breached s. 36 by bringing six actions and threatening others. The actions alleged breach of compromise (a previous court had granted Telecom an interim injunction over this), Fair Trading Act violations, copyright infringement and passing off. Clear

31 Id. at 652.

32 Id. at 652. "It may be that the time will come when the relationship between s. 36 and s. 14 of the New Zealand Bill of Rights Act 1990 must be considered".

33 [1992] 3 NZLR 247.

had asked Telecom to let the Commerce Commission decide these matters but Telecom refused. Clear said that this showed Telecom's chief desire was to increase Clear's costs. Clear also alleged that Telecom had an anticompetitive policy of scrutinising all its advertising and threatening, in some cases, to bring actions under the Fair Trading Act.

Telecom asked the High Court to strike out the Statement of Claim. Smellie J. observed that the alleged conduct was at the outer limits of what was envisaged by s. 36.³⁴ His Honour referred to Australian authority that taking legal proceedings can in some circumstances amount to a prohibited use of a dominant position.³⁵ The Australian cases had not identified those circumstances. His Honour extended Geotherm's reasoning to court proceedings. Following Geotherm, Smellie J. held that to establish a breach of s. 36 by abusing judicial processes there had to be "something more" than the reasonable exercise of the rights to sue. His Honour rejected Clear's contention that Telecom's refusal to go to the Commerce Commission together with the trivial nature of the complaints was "something more".³⁶ Smellie J. noted that the Commerce Commission was a limited dispute resolution facility - a Commission decision is not binding unless both parties agree, and the Commission examines complaints less thoroughly than a court. A court provides

34 Id. at 251.

35 Id. at 252. His Honour referred to Queensland Wire Industries Pty Ltd v Broken Hill Pty Co. Ltd (1989) 167 CLR 177 and Australasian Performing Rights Association Ltd v Ceridale Pty Ltd (1991) ATPR para 41-074.

36 Id. at 255.

a final and binding decision.³⁷ His Honour held that he could not rule that Telecom's complaint lacked merit.³⁸ Smellie J. examined the complaints on the information he had before him (including the injunction judge's decision) and said that he could not say the complaint was trivial. This led his Honour to strike out Clear's Statement of Claim.

Unlike Geotherm, Clear did not allege unethical behaviour such as perjury or assisting other objectors. The facts did not indicate that Telecom complained about all of Clear's advertising. This shows Telecom did not object on all possible occasions without regard to the merits. With respect this decision seems correct. The facts did not support Telecom having an anti-competitive purpose, let alone using its dominant position. There is nothing wrong in not wanting to go to a limited disputes tribunal or in scrutinising a competitor's advertising. Indeed, the Fair Trading Act, as consumer protection legislation which allows a competitor to complain about such breaches, encourages it. The complaints were not trivial. Telecom did not use its capital resources to bring actions that a nondominant firm would not have done. Indeed, a nondominant firm could act just the same. The case indicates that New Zealand courts may use an objective approach to determine whether a firm has breached s. 36. The judge read the proceedings to decide whether the complaints were trivial. He did not ask whether Telecom believed them to be trivial.³⁹

37 Ibid.

38 Ibid.

39 The related issue of whether the enforcement of intellectual property rights could breach s. 36 arose in Dunlop Flexible Hoses Ltd v Hose Supplies (NZ) Ltd, unreported, H.C., Tauranga, CP 74/91, Fisher J.

Australia:

Australian courts have not discussed the issue of predatory litigation to the same extent as the Court of Appeal in Geotherm. Cadbury Schweppes Pty Ltd v Kenman Developments Pty Ltd⁴⁰ dealt directly with the issue. There, the plaintiff alleged the defendant had breached s. 46 of the Trade Practices Act by bringing an untenable claim. Cadburys had sought an injunction against Kenman to stop Kenman selling chocolate bars which had a similar wrapping to a well-known Cadbury's brand. This allegedly infringed the Trade Practices Act and was passing off. Jenkinson J. declined to grant the injunction, stating that the wrappings were quite different and it was unlikely that anyone could mistake the two. Cadburys did not abandon its action and his Honour adjourned it for a substantive hearing. Kenman then brought a s. 46 action alleging that Cadburys had an improper motive in bringing and continuing the above proceedings as they were untenable, unreasonable and doomed to failure. Kenman did not allege any other anticompetitive conduct. Cadburys sought to have the proceedings struck out. Olney J. held that the only way to infer the

Dunlop obtained an interim injunction (based on s. 9 of the Fair Trading Act and passing off) to prevent Hose Supplies from selling and distributing industrial rubber hoses with colour spiral stripes. Hose Supplies claimed (inter alia) Dunlop which had 63 per cent of the market was breaching s. 36. Fisher J. did not afford the defence any significant weight in determining an interim injunction. His Honour noted: "I have some doubts as to whether the enforcement of rights in this fashion could ever be regarded as a breach of s. 36 of the Commerce Act".

40 (1991) ATPR para 41-116. See also, Australasian Performing Rights Association Ltd v Ceridale Pty Ltd, supra, note 35; Broderbund Software Inc. v Computermate Products (Australia) Pty Ltd (1992) ATPR para 41-155 which dealt with the antitrust/intellectual property interface. On this subject see Trade Practices Background Paper, Application of the Trade Practices Act to Intellectual Property (July 1991).

anticompetitive motive was from Cadburys have commenced and continued the proceedings.⁴¹ His Honour read the earlier proceedings and said that the issue was triable, noting that Jenkinson J. had observed that when the case went to a full hearing he would have great difficulty in predicting the outcome. Thus, there was nothing to justify a breach of s. 46.⁴² Olney J. held that failing to obtain interlocutory relief at a very early stage of proceedings did not mean that continuation of the proceedings was taking advantage of market power.⁴³ With respect, this seems correct. Success or lack of it at an interlocutory stage does not determine the final result. A nondominant firm could continue with proceedings after an interlocutory stage. Similarly, a continuation does not indicate that a firm has the proscribed anticompetitive purposes. His Honour did, however, note that "[t]here may well be circumstances in which the unreasonable pursuit of a claimed legal right against a less powerful competitor by a corporation with substantial market power could amount to taking advantage of that power but that case is not this case".⁴⁴ Apart from saying that the pursuit must be unreasonable Olney J. did not indicate what the circumstances could be. The case lends support to the view that the test of whether pursuit is unreasonable is objective. As in Telecom,⁴⁵ the Court looked at the predicate suit and determined whether it had objective merit.

41 Id. at 52, 757.

42 Ibid.

43 Ibid.

44 Ibid.

45 (1992) 40 CPR [3d] 289 (Competition Trib.).

Canada:

Director of Investigation and Research v Laidlaw Waste Systems Ltd is the leading Canadian case. The Director of Investigations and Research brought an abuse-of-dominance case against Laidlaw Waste Systems Ltd before the Competition Tribunal. Laidlaw was the dominant firm in waste collection and disposal services in four areas on Vancouver Island. The Director alleged a number of abusive practices including predatory litigation. As for the latter, the Tribunal noted that Laidlaw used its lawyers to threaten legal action against customers. In their threatening letters the lawyers said that Laidlaw had brought many actions against customers and had always been successful. In reality neither statement was true. The Tribunal noted the danger of abusive litigation and threats thereof to competition and quoted a large extract on the topic from Bork's The Antitrust Paradox.⁴⁶ The Tribunal strongly criticised Laidlaw's litigation practice.

"No one can read the evidence concerning the use Laidlaw made of litigation and the threat of litigation in this case without a sense of outrage. The respondent used its vastly larger size and economic resources together with the threat of litigation to prevent customers from switching to competitors. It commenced spurious litigation and threatened litigation against its competitors to drive or attempt to drive them out of business by raising their costs of doing business. This is certainly predatory behaviour".⁴⁷

The Tribunal also commented:

"It would be hoped that when Courts become aware of this kind of oppressive use of the legal system they would at the very least be prepared to award costs to the Defendant on a full indemnity

46 Ibid, at 102-103; BORK, *supra*, note 1.

47 Id. at 101-102.

basis".⁴⁸

Thus, the Tribunal found such abusive litigation could be an anticompetitive act.

Although s. 79 of the Competition Act⁴⁹ does not require use of market position or taking advantage of market power, Laidlaw shows how abusive litigation is grounded in market power. Laidlaw's customers took its threats to litigate seriously because of its economic power. This supports Geotherm where the Court found threats and public statements could be the use of a dominant position if the position gave the statements the force amounting to deterrence. Laidlaw also indicates that to be an anticompetitive act, litigation must be spurious and made with the purpose of driving or attempting to drive out competitors. The case also shows how a dominant firm can use litigation against its customers. The threats and the misrepresentations as to its litigation success would deter a customer from leaving Laidlaw.

48 Id. at 103.

49 Section 79 provides:

- (1) Where, on application by the Director, the Tribunal finds that:
 - (a) one or more persons substantially or completely control, throughout Canada or any area thereof, a class or species of business,
 - (b) that person or those persons have engaged in or are engaging in a practice of anticompetitive acts, and
 - (c) the practice has had, is having or is likely to have the effect of preventing or lessening competition substantially in a market,

the Tribunal may make an order prohibiting all or any of those persons from engaging in that practice.

United States Case-law:

Introduction:

Not surprisingly, United States jurisprudence contains the most case-law on whether the abuse of judicial and administrative processes can violate the antitrust laws. Claims have arisen out of a firm opposing a competitor's request for governmental approval or for a licence necessary to establish or expand business activities. These claims have included opposition to: approval to establish or expand a regulated entity;⁵⁰ grants of licensing and operating rights;⁵¹ issue of building permits;⁵² zoning and land use decisions;⁵³ grants of cable and other franchises;⁵⁴ approval of new products;⁵⁵ certification of

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- 50 E.g. St Joseph's Hosp. Inc. v Hospital Corp., 795 F. 2d 948 (11th Cir. 1986) (hospital's request for a certificate of need to expand facilities or to enter a health care market); Central Bank of Clayton v Clayton Bank, 424 F. Supp. 163 (E.D. Mo. 1976) (issuance of a bank charter), aff'd mem., 553 F. 2d 102 (8th Cir.), cert denied, 433 U.S. 910 (1977).
 - 51 California Motor Trans. Co. v Trucking Unlimited, 404 U.S. 508 (1972) (highway carrier operating rights).
 - 52 Franchise Realty Interstate Corp. v San Francisco Local Joint Executive Bd of Culinary Workers, 542 F. 2d 1076 (9th Cir. 1976), cert denied, 430 U.S. 940 (1977).
 - 53 Video Int'l Prod. Inc. v Warner-Anex Cable Communications, Inc., 858 F. 2d 1075 (5th Cir. 1988) (alleging use of zoning ordinances to put cable television operator out of business), cert denied, 490 U.S. 1047 (1989); Westborough Mall, Inc. v City of Cape Girardeau, 693 F. 2d 733 (8th Cir. 1982) (shopping mall zoning), cert denied, 461 U.S. 945 (1983).
 - 54 Catalina Cablevision Assocs. v City of Tucson, 745 F. 2d 1266 (9th Cir. 1984).
 - 55 Israel v Baxter Laboratories, Inc., 466 F. 2d 272 (DC Cir. 1972) (alleging conspiracy to influence F.D.A. to deny fair consideration of new drug applications).

personnel;⁵⁶ request for government subsidy;⁵⁷ and issue of municipal bonds.⁵⁸

The aspects of the opposition which led to the antitrust claims included opposition when there was no hope of success⁵⁹ and opposition with the purpose of delaying entry or burdening the competitor rather than winning.⁶⁰ Anticompetitive purpose was evinced by there being no hope of success, bringing actions in a tribunal known to lack jurisdiction,⁶¹ or repeatedly and automatically opposing without regards to the merits⁶² or taking so long that the competitor is denied access to the administrative process.⁶³

Claims have also alleged abuse of the judicial process. These claims have involved baseless litigation as shown by meritless claims such as bad faith prosecutions of patent infringements and unfounded allegations of stolen trade

56 Mercy Peninsula Ambulance, Inc. v County of San Mateo, 592 F. Supp. 956 (ND Cal 1984) (certification of paramedic personnel), aff'd, 791 F. 2d 755 (9th Cir. 1986).

57 Aloha Airlines, Inc. v Hawaiian Airlines Inc., 349 F. Supp. 1064 (D. Hawaii 1972), aff'd, 489 F. 2d 203 (9th Cir. 1973), cert denied, 417 U.S. 913 (1974).

58 Razorback Ready Mix Concrete Co. v Weaver, 761 F. 2d 484 (8th Cir. 1985).

59 Litton Systems v AT & T, 700 F. 2d 785 (2d Cir. 1983), cert denied, 464 U.S. 1073 (1984).

60 *Id.*

61 MCI Communications v AT & T, 708 F. 2d 1081, 1156 (7th Cir. 1983), cert denied, 464 U.S. 891 (1983).

62 Clipper Express v Rocky Mountain Motor Tariff Bureau, 690 F. 2d 1240, 1253-1254 (9th Cir. 1982), cert denied, 459 U.S. 1227 (1983).

63 Greenwood Utilities Commission v Mississippi Power Co., 751 F. 2d 1484, 1498 n. 9 (5th Cir. 1985).

secrets,⁶⁴ or bad faith intervention in the bankruptcy proceedings of a competitor,⁶⁵ or claims brought with a known lack of standing,⁶⁶ or before a court lacking jurisdiction.⁶⁷

Misrepresentations made in judicial proceedings have been the basis for an antitrust challenge.⁶⁸ Litigation brought for the alleged purpose of other than winning has been challenged.⁶⁹ These purposes have included burdening a competitor with heavy costs,⁷⁰ generating adverse publicity,⁷¹ unearthing trade secrets by pretrial discovery⁷² and forcing a competitor to make public disclosure of its financial liability.⁷³ These purposes show an ultimate purpose of eliminating or decreasing competition in an existing market, or delaying or preventing entry into a market.

The above conduct may merely represent an aggrieved incumbent firm

64 CVD, Inc. v Raytheon Co., 769 F. 2d 842 (1st Cir. 1985), cert denied, 475 U.S. 1016 (1986).

65 In re Amerco, 109 F.T.C. 135 (1987).

66 Landmarks Holding Corp. v Bermant 664 F. 2d 891 (2d Cir. 1981).

67 MCI Communications v AT & T, 708 F. 2d 1081, 1156 (7th Cir. 1983), cert denied, 464, U.S. 891 (1983).

68 Code Corp. v Racal Milgo, Inc., 1984-1 Trade Cas (CCH), para 65, 853.

69 Greenwood Utilities Commission v Mississippi Power Co., 751 F. 2d 1484 (5th Cir. 1985).

70 Grip-Pak v Illinois Tool Works, 694 F. 2d 466, 472 (7th Cir. 1982), cert denied, 461 U.S. 958 (1983).

71 Energy Conservation v Heliodyne, 698 F. 2d 386, 389 (9th Cir. 1987).

72 Grip-Pak v Illinois Tool Works, 694 F. 2d 466, 472 (7th Cir. 1982), cert denied, 461 U.S. 958 (1983).

73 *Ibid.*

legitimately using judicial and administrative processes. The first amendment to the United States Constitution guarantees the right to free speech and this may protect such conduct.⁷⁴ The need to punish anticompetitive abuse of judicial and administrative processes and yet still protect the right to petition the government led the courts to develop the Noerr-Pennington doctrine.

Development of the Noerr-Pennington Doctrine:

This doctrine exempts certain petitioning behaviour from antitrust liability. The Supreme Court established the immunity in Eastern Railroad Presidents Conference v Noerr Motor Freight, Inc.⁷⁵ and United Mine Workers v Pennington.⁷⁶ The doctrine immunises genuine efforts to influence governmental entities from antitrust scrutiny even if those efforts have anti-competitive results. The Court extended immunity to adjudication in California Motor Transport Company v Trucking Unlimited.⁷⁷ The Court further refined the doctrine in Allied Tube & Conduit Corp. v Indian Head Inc.⁷⁸, City of Columbia v Omni Outdoor Advertising, Inc.⁷⁹ and Professional Real Estates

74 The first amendment to the Constitution of the United States declares: "Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof; or abridging the freedom of speech, or of the press; or the right of the people to people peaceably to assemble, and to petition the government for a redress of grievances" U.S. CONST. amend. I.

75 365 U.S. 127 (1961).

76 381 U.S. 657 (1965).

77 404 U.S. 508 (1972).

78 108 S. Ct. 1, 931 (1988).

79 111 S. Ct. 1, 344 (1991).

Investors, Inc. v Columbia Pictures, Industry Inc.⁸⁰ In spite of all this, the doctrine's scope remains unclear.

In Noerr a group of truckers and their trade association sued a group of railroads, an association of railroad presidents and a public relations firm. The truckers alleged that the railroads had hired the public relations firm to direct a publicity campaign to discredit the truckers and to lobby for anti-trucking laws. The campaign succeeded as the Government of Pennsylvania vetoed a Bill which would have increased trucks' weight limits on highways. The truckers alleged that the campaign's purpose was to eliminate them from the long distance freight business. They also alleged that the campaign was deceptive because the railroads sponsored third parties to vilify the truckers, thus hiding the railroads' participation. The trial court found that the railroads had breached the Sherman Act and the Third Circuit Court of Appeals, by a majority, affirmed. A unanimous Supreme Court reversed the decision, holding that joint efforts to influence a legislature to pass anticompetitive legislation does not fall within the Sherman Act.⁸¹ The Court noted that the Sherman Act does not apply to valid exercises of government power.⁸² Thus, a validly enacted anticompetitive law does not breach the Sherman Act. Since the Sherman Act does not cover such laws it could not cover attempts to persuade legislatures to pass such laws.⁸³ The Court noted that lobbying efforts are essentially dissimilar to agreements

80 113 S. Ct. 1920 (1993).

81 365 U.S. at 145.

82 Id. at 136.

83 Ibid.

that the Sherman Act traditionally condemns. The Sherman Act regulates business activity - not political activity. The Court held that making lobbying an antitrust violation would impair citizens' ability to inform government of their wishes, thus inhibiting democracy. Finally, the Court noted that to interpret the Sherman Act so as to prohibit lobbying would "raise important constitutional questions".⁸⁴

The Court discussed whether the railroads' purpose in lobbying, namely, to eliminate the truckers from the relevant market, could affect liability. It held that it did not.

"[T]he right of the people to inform their representatives in government of their desires with respect to the passage or enforcement of laws cannot properly be made to depend upon their intent in doing so. It is neither unusual nor illegal for people to seek action on laws in the hope that they may bring an advantage to themselves and a disadvantage to their competitors. ... Indeed, it is quite probable people with just such a hope of personal advantage who provide much of the information upon which governments must act".⁸⁵

Similarly, the railroads' unethical behaviour did not affect liability. The Court agreed that the railroads did act unethically, but noted that if the Sherman Act establishes a code of ethics at all, "it is a code that condemns trade restraints, not political activity".⁸⁶

The Court did not hold that all attempts to influence the government are immune.

84 Id. 74. In a footnote the Court stated it was unnecessary to decide whether the first amendment protected the railroad's activities.

85 Id. at 139.

86 Id. at 140.

"[T]here may be situations in which a publicity campaign, ostensibly directed toward influencing government action is a mere sham to cover what is actually nothing more than an attempt to interfere directly with the business relationships of a competitor and the application of the Sherman Act would be justified".⁸⁷

Most subsequent litigation has attempted to define the limits of this "sham exception".

In Pennington the Court extended Noerr immunity to attempts to influence the executive branch of government. A small coal company accused the United Mine Workers Union of conspiring with large coal operators to urge the Secretary of Labour to establish a high minimum wage for coal workers and to dissuade the Tennessee Valley Authority from buying nonunion coal. The conspirators hoped that these government actions would drive the small companies from the market. The Supreme Court held that the Noerr immunity covered the conspirators.⁸⁸ It reaffirmed that an anticompetitive purpose does not remove the immunity. "Joint efforts to influence public officials do not violate the antitrust laws even though intended to eliminate competition".⁸⁹

In California Motor Transport Co. the Court extended Noerr protection to attempts to influence adjudicatory bodies. The plaintiffs (15 small Californian trucking firms) alleged that the defendants (19 large trucking firms) had conspired to undermine the plaintiffs' position in the Californian trucking market. The defendants did so by filing groundless proceedings before State

87 Id. at 144.

88 For a recent commentary examining the role of unions engaging in predatory litigation, see Durie and Lemley, The Antitrust Liability of Labour Unions for Anticompetitive Litigation, CAL. L. REV., 757 (1992).

89 381 U.S. at 670.

agencies and courts to prevent the plaintiffs obtaining the necessary administrative approvals to enter the market. The plaintiffs alleged that the defendants instituted the proceedings "with or without probable cause"⁹⁰ and "regardless of the merits"⁹¹ of the case. The case went to the Supreme Court on the pleadings as the trial court had dismissed it, because of Noerr while the Ninth Circuit Court of Appeals had reversed. Justice Douglas, writing for the majority, held that Noerr covered legitimate attempts to influence adjudicatory proceedings.⁹² The Court suggested that either improper purpose or improper means might make petitioning a sham and means that are proper before one branch of government might not be before a different branch. Misrepresentations condoned in a political arena are not immune to the adjudicatory processes.⁹³ The Court held that the complaint stated a cause of action within Noerr's sham exception because of the allegations that the conspirators were not genuinely intent upon influencing public officials but upon harassing the plaintiffs' cases.⁹⁴ The facts supported this; namely, the defendants sought to bar their competitors from meaningful access to adjudicatory tribunals and so to usurp that decision-making process. The Court quoted the plaintiffs' allegation that the defendants instituted proceedings with or without probable cause. It gave examples of conduct, other than access-

90 404 U.S. at 509.

91 Ibid.

92 Id. at 510-511.

93 Id. at 513.

94 Id. at 511-513.

barring, that would not be immune. These examples were perjury of witnesses, use of a fraudulently-obtained patent to exclude competitors, conspiracy with government officials and bribery. This list was not exhaustive and the Court stated that "there are many other forms of illegal and reprehensible behaviour which may corrupt the administrative or judicial processes and which may result in antitrust violations".⁹⁵ Justice Douglas held that baseless litigation can fall within the sham exception.

"One claim which a court or agency may think baseless may no unnoticed but a pattern of baseless repetitive claims may emerge which leads the factfinder to conclude that the administrative and judicial processes have been abused".⁹⁶

Lower courts have often cited this passage as setting out the requirements for the sham exception for litigation.⁹⁷

Subsequent Supreme Court cases have not provided much further guidance as to when litigation falls within the sham exception. In Allied Tube⁹⁸ the Court distinguished between a petitioner's liability for harm caused by the requested governmentally-imposed restraint (the petitioner was not liable) and harm which the petitioning directly caused (the petitioner was liable). It also distinguished between petitioning which is not genuinely intended to influence government action (a sham) and activity which is merely unethical (not a sham).

95 Id. at 513.

96 Ibid.

97 Central Bank of Clayton v Clayton Bank 424 F. Supp. 163 (E.D. Mo. 1976), aff'd mem., 553 F. 2d 102 (8th Cir.), cert denied, 433 U.S. 910 (1977).

98 108 S. Ct. 1, 931 (1988).

In the decision, Omni Outdoor Advertising,⁹⁹ Justice Scalia elaborated on the sham exception.

"The sham exception to Noerr encompasses situations in which persons use the governmental process - as opposed to the outcome of that process - as an anticompetitive weapon. A classic example is the filing of frivolous objections to the license applications of a competitor with no expectation of achieving denial of the license but simply in order to impose expense and delay. A sham situation involves a defendant whose activities are not genuinely aimed at procuring favourable government action at all, not one who genuinely seeks to achieve his governmental results but does so through improper means".¹⁰⁰

Professional Real Estate Investors, Inc. v Columbia Pictures Industries, Inc.¹⁰¹ is the Supreme Court's most recent Noerr decision. The case concerned videodiscs. When a resort hotel operator started renting videodiscs to patrons for in-room viewing, without payment of royalties, eight motion picture studios filed a single, apparently reasonable case alleging copyright infringement. The studios lost in a controversial copyright decision.¹⁰² The hotel operator sued alleging a Noerr violation. The operator lost at trial and in the Ninth Circuit Court of Appeals. The Court announced a two part test for a violation. First, the challenged suit must be objectively baseless. Second, the person who brought the suit must have had the intent to harm competition with the "governmental process". Both elements have to be met.

Thus, Noerr protects legitimate attempts to petition government, including

99 111 S. Ct. 1, 344 (1991).

100 Id. at 1, 345 (citations omitted) (emphasis in original).

101 113 S. Ct. 1, 920 (1993).

102 Id. at 1, 930. The Court noted scholarly criticism of the decision.

litigation. Not all petitioning is protected. Noerr does not apply when defendants' activities are a sham. One must remember that being a sham does not make the activity an antitrust violation. A plaintiff still has to establish the elements of a Sherman Act violation.¹⁰³

The Supreme Court has not clearly established the doctrine's scope. Commentators have described the doctrine as a "quagmire".¹⁰⁴ The lower courts agree that the doctrine does not protect sham activities. However, they differ over what constitutes a sham. It is necessary to examine what the lower courts consider are the requirements of a sham.

The Requirements of a Sham:

The courts generally agree that sham litigation occurs when a person litigates, not to obtain a result he or she seeks, but rather to impose burdens, delays or costs directly on a competitor. The Fifth Circuit expressed the test as the following:

"The sham exception comes into play when the party petitioning the government is not at all serious about the object of that petition but engages in the petitioning activity merely to inconvenience its competitor. Thus the sham exception is said to apply when one party has begun that litigation not to win that litigation but rather to force its competitor to waste time and

103 See CVD, Inc. v Raytheon Co. 769 F. 2d 842, 851 (1st Cir. 1985) (holding that plaintiff must also prove elements of a Sherman Act violation to succeed), cert denied, 475 U.S. 1016 (1986); Clipper Express v Rocky Mountain Motor Tariff Bureau Inc. 690 F. 2d 1240, 1247 n. 7, 1259 (9th Cir. 1982) (holding that if antitrust plaintiff establishes that Noerr immunity does not apply, it must then establish elements of a Sherman Act violation), cert denied, 459 U.S. 1227 (1983).

104 Costilo, Antitrust Nearest Quagmire: The Noerr-Pennington Defence, 66 MICH. L. REV., 333 (1967).

money defending itself. Similarly a party that petitions the government by engaging administrative processes only to preclude or delay its competitor's access to those processes may be liable for antitrust damages under the sham exception".¹⁰⁵

In similar vein the Seventh Circuit enunciated the test in the following way:

"Without a doubt the intention to harm a competitor is not sufficient to make litigation or administrative proceedings a sham. That anti-competitive motive is the very motive protected under Noerr-Pennington. Rather the requisite motive for the sham exception is the intent to harm one's competitors, not by the result of the litigation but by the simple fact of the institution of the litigation".¹⁰⁶

Judge Richard Posner, in an oft-cited statement in Grip-Pak v Illinois Tool Works said that "the line is crossed when the plaintiff's purpose is not to win a favourable judgment against a competitor but to harass him and deter others by the process itself, regardless of the outcome of litigating".¹⁰⁷

Thus, the various circuits agree on the requisite purpose. They do not agree on what the situation is when a firm has mixed purposes: for example, it hopes to harass the competitor but also to win. Some courts only find a sham when the harassment motive is the firm's sole motive,¹⁰⁸ whereas others hold that it need only be the primary motive.¹⁰⁹ Grip-Pak falls into the latter category and offers the following test: Noerr does not protect those cases which

105 Video Int'l Prod. Inc. v Warner-Amex Cable Communications, Inc., 858 F. 2d 1075 (5th Cir. 1988).

106 MCI Communications v AT & T, 708 F. 2d 1081 at 1152 (7th Cir. 1983), cert denied, 464 U.S. 891 (1983).

107 *Supra*, note 72, at 472.

108 Westmac v Smith, 797 F. 2d 313 (6th Cir. 1986), cert denied, 479 U.S. 1035 (1987).

109 Grip-Pak v Illinois Tool Works, 694 F. 2d 466 (7th Cir. 1982).

would not have been brought but for the injury that a rival suffers simply from being enmeshed in the litigation process, regardless of outcome.¹¹⁰

While the test for a sham is easy to state, in practice it is harder to apply. The problem is in determining a firm's purpose. Very few cases provide extrinsic evidence of a firm's purpose and, usually, courts have to infer it from other evidence. The courts have devised various tests for determining whether a firm has the requisite purpose.

Some courts, following California Motor Transport,¹¹¹ require a pattern of repetitive claims.¹¹² This indicates that a single suit cannot be a sham. However, other courts have rejected this and hold that a single suit may be a sham.¹¹³ Some circuits, again relying on California Motor Transport, hold that only activity which denies a competitor "free and meaningful access to the agencies and courts" can be a sham.¹¹⁴

The courts disagree on whether a successful case can be a sham. They

110 Id. at 472.

111 Supra, note 76.

112 RazorBack Ready Mix Concrete Co. Inc. v Weave, 761 F. 2d 484 (8th Cir. 1985); AirCapital Cablevision, Inc. v Starlink Communications Group, Inc. 634 F. Supp. 316, 321 (D. Kan 1986) See Balmer, supra, note 8, 49-56; Myers, supra, note 8, 619-624; Fischel, Antitrust Liability for Attempts to Influence Government Action: The Basis and Limits of the Noerr and Pennington Doctrine 45 U. CHI. L. REV. 80 at 108-110.

113 Clipper Express v Rocky Mountain Traffic Bureau, Inc., 690 F. 2d 1240, 1254-57 (9th Cir. 1982); Interstate Properties v Pyramid Co. of Utica, 586 F. Supp. 1160, 1162 (S.D.N.Y. 1984).

114 Central Bank of Clayton v Clayton Bank, 424 F. Supp. 163 (E.D. Mo. 1976), aff'd mem., 553 F. 2d 102 (8th Cir.), cert denied, 433 U.S. 910 (1977).

accept that in most cases petitioning is not a sham if it succeeds. Some courts present this as a categorical rule; namely, a successful case means no sham.¹¹⁵ These courts usually hold that this is so, only in the absence of fraud or collusion.¹¹⁶ Some courts say success creates a strong presumption that the case is not a sham.¹¹⁷ Other courts hold that while success is an important factor to consider, it is not determinative.¹¹⁸ They reject any rule or presumption that successful petitioning can never be a sham. "The determinative inquiry is not whether the suit was won or lost, but whether it was significantly motivated by a genuine desire for relief".¹¹⁹

The success of a case is an issue as it strongly suggests that the petitioning was reasonable or not baseless. Some courts hold that only baseless cases can be a sham.¹²⁰ However, an unsuccessful case does not mean that the case is baseless. Many reasonable cases are lost. Most courts attempt to assess the objective legal merit of the challenged suit to determine whether it is baseless. Standards such as "abusive", "frivolous" or "lacking probable cause" which courts have adopted are synonyms for baselessness. Most courts require baselessness

115 Greenwood Utilities Commission v Mississippi Power Co., 751 F. 2d 1484, 1500 (5 Cir. 1985); Columbia Pictures Indus., Inc. v Redd Horne, Inc., 749 F. 2d 154 161 (3d Cir. 1984).

116 Greenwood Utilities Commission, *ibid*; Allied Tube 108 S. Ct. 1, 931, 1, 938 (1988).

117 Westmac, Inc. v Smith, 797 F. 2d 313 (6th Cir. 1986), cert denied, 479 U.S. 1035 (1987).

118 Boulware v State of Nevada 1992 - 1 Trade cases para 69, 771 (9th Cir.).

119 In re Burlington Northern, Inc., 822 F. 2d 518, 528 (5th Cir. 1987), cert denied, 484 U.S. 1007 (1988).

120 Ernest W. Hahn v Coddington, 615 F. 2d 830, 841 (9th Cir. 1980).

unless the petitioning is unethical,¹²¹ advanced without regard to the merits¹²² or part of a larger anticompetitive scheme.¹²³ One case held that a defence was baseless and thus a sham.¹²⁴ Other courts have found baselessness where the antitrust defendant brought an action without proper standing and before a body lacking jurisdiction to determine the case.¹²⁵

Other courts focus on showing that the defendant behaved unethically; for example, engaging in perjury, misrepresentation or bribery.¹²⁶ Omni Outdoor Advertising held that unethical behaviour is irrelevant if the petitioner "genuinely seeks to achieve his governmental result".¹²⁷ This conflicts with California Motor Transport Co. which held that misrepresentations and other improper actions would not be immune in the adjudication context.¹²⁸ It is perhaps relevant that Omni Outdoor Advertising and Allied Tube dealt with alleged abuse in the legislative arena. The Allied Tube Court also suggested that unethical behaviour may be an antitrust violation independent of Noerr.

121 Walker Process Equip., Inc. v Food Mech. & Chem. Corp., 382 U.S. 172 (1965).

122 In re Burlington Northern, Inc., supra, note 119; Westborough Mall Inc. v City of Cape Girardeau, 693 F. 2d 733, 745-46 (8th Cir. 1982).

123 Coastal States Marketing v Hunt, 694 F. 2d 1358 (5th Cir. 1983).

124 In re Burlington Northern Inc., 822 F. 2d 518 (5th Cir. 1987), cert denied, 484 U.S. 891 (1988).

125 MCI Communications v AT & T, 708 F. 2d 1081 (7th Cir. 1983), cert denied, 464 U.S. 891 (1983).

126 Ad Visor, Inc. v Pacific Telephone & Telegraph Co., 640 F. 2d 1107 (9th Cir. 1981).

127 111 S. Ct. at 1,354 (1991).

128 404 U.S. at 513 (1965).

One case considered the speed in which a defendant pursued its case to be relevant.¹²⁹

An influential, albeit controversial, test is Judge Posner's cost-benefit analysis which his Honour enunciated in Grip-Pak.¹³⁰ This test requires a court to inquire whether a rational petitioner would have pursued the matter if motivated solely by the value of obtaining the requested relief. Under this test a lawsuit brought for anticompetitive purposes could be a sham even though not wholly lacking in merit. A lawsuit is a sham unless it is cost-justified.

It is still unclear whether the Noerr doctrine is based on constitutional principles or an interpretation of the Sherman Act. In Noerr, the Court based its decision on statutory interpretation although it noted an alternative interpretation would raise important constitutional questions. California Motor Transport Co. grounded the doctrine in the first amendment. Recent Supreme Court authority has not clarified things. Some courts have held that despite its origins the Noerr doctrine is now a matter of constitutional law,¹³¹ while others insist it is grounded in the Sherman Act.¹³²

129 Boulware v State of Nevada 1992 - 1 Trade Cases para 69,771 (9th Cir.).

130 694 F. 2d 466 (7th Cir. 1982), cert denied, 461 U.S. 958 (1983).

131 Clipper Express, supra, note 62; also Note, Noerr-Pennington Immunity from Antitrust Liability made Clipper Express v Rocky Mountain Motor Tariff Bureau Inc: Replacing the Sham Exception with a Constitutional Analysis, 69 CORNELL L. REV., 1305, 1306-12 (1984) [hereinafter Cornell Note]; Sullivan, Developments in the Noerr Doctrine, 56 ANTITRUST L.J., 361 (1987).

132 See Handler & De Sevo, The Noerr Doctrine and its Sham Exception, 6 CARDOZO L. REV., 1, 3-5 (1984) and cases therein cited.

Relevant Issues:

Despite Noerr's constitutional overtones and the differences between the language of the Sherman Act and s. 36 of the Commerce Act, it is a useful guide to abuse of administrative and judicial processes. The American cases identify a number of factors and tests which are relevant in determining a sham. Some of these will be relevant in determining whether an alleged abuse of a judicial or administrative process breaches s. 36.

Purpose:

Noerr is particularly relevant as to purpose. As mentioned above, a sham occurs when a firm litigates, not to obtain the requested relief, but rather to impose costs etc directly on a rival; that is, when a firm uses the process as opposed to the outcome of that process as an anticompetitive weapon. There is no antitrust liability if a firm litigates with the purpose that the result of the litigation will harm competitors. The firm is not seeking to use the litigation process as an anticompetitive weapon.

One can argue that Geotherm¹³³ makes the same distinction. The Court of Appeal held:

"Even a monopoly must be entitled to make a case to the appropriate licensing or other authority for the preservation of its monopoly. The submission of reasonable arguments to that end and the taking of reasonable steps to prepare the case could not in themselves amount to a use of a dominant position in the market".¹³⁴

133 Supra, note 17.

134 Id. at 655.

Elsewhere the Court said that "[i]t is difficult to envisage a situation in which there will be a contravention [of s. 36] by the reasonable exercise of rights of objection".¹³⁵ The Court said this was because reasonable arguments, etc, were not a use of a dominant position. One can also say, however, that reasonable arguments etc do not show the requisite purpose. Preserving a monopoly means a dominant firm wants to thwart competitors. If a dominant firm makes reasonable arguments and succeeds the authority will make a decision which will have the likely effect of preserving the dominant firm's monopoly. Making reasonable argument indicates that the dominant firm's purpose was to achieve the requested result. This situation does not breach s. 36. If a dominant firm makes unreasonable arguments, it is not going to win. It is not going to achieve the result it requests. It is not going to get a decision that will preserve its monopoly. Presuming that the dominant firm knows its arguments are unreasonable and therefore, that it is unlikely to win, a dominant firm's purpose in objecting can only be to harm a competitor, by the process of objecting; for example, by increasing costs or delaying or deterring entry. In such a situation a dominant firm cannot have a genuine purpose to win. Its purpose must be to use the process as an anticompetitive weapon.

Even if this argument is not accepted, the sham exception is still relevant. If a firm has the purpose of harming a rival by using the judicial process as a weapon, it must also have the purpose of restricting, preventing or deterring competition, thus falling within the scope of the s. 36(1) prohibition.

Under s. 36 the requisite purpose need not be the sole nor dominant

135 Id. at 651.

purpose, but it must be a substantial purpose.¹³⁶ This is a lower standard than Grip-Pak's principal purpose test.

Baseless Claims:

Geotherm, Telecom¹³⁷ and Cadbury¹³⁸ indicate that a case must be baseless before s. 36 is breached. This is in line with Professional Real Estate.¹³⁹ The Telecom and Cadbury courts found that the defendants' arguments were not meritless. A finding that litigation is baseless is extremely relevant in determining whether the firm which brought the litigation has breached s. 36. Such a finding helps establish the "purpose" and "use" elements. A litigant will lose a baseless case. Thus, the expected value of the legal outcome of a baseless suit is zero. The only value can be in harming competitors by the process of litigation. Thus, the purpose of bringing such a suit must be to harm competitors. This is also relevant to "use", as presumably only a dominant firm could afford to litigate such a case. A firm in a highly competitive market could not afford to spend its resources on trying a case it had no hope of winning.

Courts have not established a standard by which to determine whether a base is baseless. Telecom indicates that a colourable claim is not a baseless claim. The American courts have not established any criteria any clearer than

136 Section 2(5) Commerce Act.

137 Supra, note 4.

138 Supra, note 5.

139 Supra, note 121.

that. As Areeda and Hovenkamp note, it is unrealistic to ascribe a numerical value to reasonableness; for example, a 50 per cent chance of victory makes the case reasonable, whereas a 10 per cent chance does not. One cannot be that precise in predicting a lawsuit's outcome.¹⁴⁰ Courts also have to protect novel claims, for it is only by such claims that the law can advance. Perhaps the best standard is that an unreasonable argument is one that is implausible or without legal foundation.

Successful Claims:

Should New Zealand adopt a test that a successful suit cannot amount to a breach of s. 36?¹⁴¹ The rationale behind this, is that success indicates that the claim was valid and belies the notion that the petitioner was not actually seeking the relief obtained or, in Geotherm's words, a successful suit indicates that the petitioner used reasonable arguments. However, a "per se" approach to successful suits is inadvisable. A successful suit may be part of an anticompetitive policy of objecting automatically (that is, with or without probable cause and without regard to the objections' merits). Such objections are evidence that the objector may have breached s. 36. They indicate that the objector's real purpose was not to win. If the objector really wanted to win it would only object when it had probable cause or a chance of winning. If the

140 P. AREEDA & H. HOVENKAMP, ANTITRUST LAW SUPPLEMENT SUPPLEMENT 29-30 (1990).

141 Id. at 25-29; Hurwitz, *supra*, note 8, at 108-109; Calkins Developments in Antitrust and the First Amendment: The Disaggregation of Noerr 57 ANTITRUST L.J., 361, 361-362 (1988).

objector's purpose is not to win it must be to entangle the firm it is objecting against, in proceedings. It would not be rational for a nondominant firm to object automatically. If a firm has such a policy, a "lucky break" in the form of a successful case should not protect it. Colloquially, a couple of good apples should not sweeten a rotten barrel. An example is California Motor.¹⁴² The Supreme Court held that it was a sham where a defendant brought repetitive suits with or without probable cause and without regard to the merits. This was so despite the defendants having succeeded in 21 out of 40 suits. The argument applies to New Zealand. Objecting automatically is not a reasonable exercise of the rights of objection. Geotherm alleged Electricorp had objected automatically and without regard to merits. This was one of the reasons why the Court of Appeal refused to strike out the Statement of Claim. This is to be contrasted with the situation in Telecom. Clear's claim alleged that Telecom had scrutinised its advertising. However, it did not allege that Telecom had automatically alleged breaches of the Fair Trading Act. On the contrary, it appears Telecom only complained about some of the advertising; that is, it did not complain without probable cause or in complete disregard of the merits.

Areeda and Hovenkamp argue that success in petitioning creates a strong presumption that petitioning is legitimate. They say only a "presumption" in order to recognise the possibilities of serious misuse of discovery or a wrongly-decided principal case or possible conspiracy with the decision-maker.¹⁴³ This seems correct. Success is an important factor for a court to consider, but for the

142 *Supra*, note 57.

143 AREEDA & HOVENKAMP, *supra*, note 140 at 28.

reasons above, it should not be determinative. Similarly, success at an interlocutory stage is strong evidence that a suit is not a sham or that the defendant used reasonable arguments. However, it should not be as strong a factor as success in the substantive hearing. The lack of merit may not become apparent until the court has considered all the evidence. Conversely, lack of success at either the interlocutory or substantive stages does not indicate a sham or lack of reasonable argument. Many reasonable arguments lose. This was the finding in Cadbury. Lack of success may be relevant but a court hearing the trade practices claim must make its own assessment of the objective merits of the predicate suit.

Single Suits:

The next issue to consider is whether a single case can lead to liability. Cadbury only involved one suit but it was not an issue. The requirement of a pattern of lawsuits was derived from California Motor Transport Co. Justice Douglas was only giving examples of sham litigation. He was not being prescriptive. There are strong arguments as to why New Zealand courts should hold that a single suit can amount to a breach of s. 36. The rationale as to why abuse of judicial processes deserves competition law attention applies to one suit as well as many suits. A single, well-timed and carefully-pleaded case with appeals can cost a competitor a large amount of money and time, even if it is frivolous. A pattern of claims should not be prerequisite but, rather, persuasive evidence of a sham. Academic authority strongly supports this.¹⁴⁴

144 See literature cited, *supra*, note 112.

Access-barring:¹⁴⁵

The requirement that a case bar a firm access to administrative or judicial processes was also derived from Justice Douglas's example in California Motor Transport Co. The New Zealand courts should not adopt this requirement. It only makes sense where a firm seeks to enter a regulated industry. This was the case in California Motor Transport Co. Denying the small firms access to administrative tribunals delayed their entry to the market. The argument does not apply to courts. The dominant firm will want its rival to have its "day in court" so it faces legal costs. Access-barring is relevant evidence in the context of a regulated industry but it should not be a required condition.

Objective or Subjective Tests:

The next issue is whether the tests should be objective or subjective. Commentators and recent United States case-law favours an objective approach.¹⁴⁶ Telecom and Cadbury support an objective test. Certainly, the courts took an objective view of the reasonableness of the predicate suits. Geotherm seems to favour an objective approach. It talks of "reasonable arguments", not of arguments the defendant believed to be reasonable. It is extremely difficult to prove subjective purpose. Extrinsic evidence is rare unless

145 See AREEDA & HOVENKAMP, *supra*, note 140, at 21; Balmer, *supra*, note 8, at 46-49; Myers, *supra*, note 8, at 610-611; Elhauge, Making Sense of Antitrust Petitioning Immunity, 80 CAL. L. REV., 1177 (1992).

146 Professional Real Estate Investors, Inc. v Columbia Pictures Industries, Inc., 113 S. Ct. 1,920 (1993); AREEDA & HOVENKAMP, *supra*, note 141, at 22-23; Myers, *supra*, note 8, at 612-619; Hurwitz, *supra*, note 8, at 93-99.

one stumbles upon a "smoking gun" or a "whistle-blower". Similarly, it is unlikely that a court would believe that a dominant firm, which presumably uses first-rate lawyers, could believe that its objectively baseless claim was valid.

Unethical Behaviour:

As mentioned above, unethical behaviour may remove Noerr immunity. This is partly because the first amendment does not cover falsehoods. Unethical conduct, by itself, is not a good indicator of sham activity. Its presence does not mean the petitioner did not genuinely seek the requested result. It may in fact be evidence that it strongly desired the result. Unethical conduct occurs in meritorious as well as baseless proceedings. Thus, New Zealand courts should only consider unethical conduct as relevant when it occurs with other conduct. By itself it is too unreliable a guide.

Re-litigation:

As mentioned above, some argue that allowing predatory litigation claims will result in relitigation of the challenged suit.¹⁴⁷ This will be an abuse of process. However, re-litigation should not be a problem. It is not a significant problem in abuse of process or malicious prosecution cases. Also, the courts will have struck out many challenged suits. Other challenged suits will have gone to trial. Often the trial court will have said that those suits were baseless or unreasonable. Relitigation cannot arise in those cases.

147 *Supra*, note 31.

Privilege:

A possible brake on predatory litigation claims brought by plaintiffs is legal professional privilege.¹⁴⁸ Generally, a dominant firm will have top lawyers. These lawyers, presumably, will have advised the dominant firm that its case is highly unlikely to succeed. Yet the dominant firm proceeds. This would be strong evidence of anti-competitive purposes and use of a dominant position. Only a dominant firm with deep pockets could afford to pay top lawyers to bring such claims. To establish purpose and use a plaintiff would have to undertake extensive discovery. However, the very documents which establish purpose and use are privileged. Thus, a plaintiff can only challenge those cases that are objectively unreasonable. Former Federal Trade Commissioner Calvani has referred to the problem of professional privilege and sham litigation claims.¹⁴⁹

Privilege raises the interesting issue of the position of lawyers who bring obviously meritless claims. Have they been knowingly concerned in a breach of the Commerce Act? If so, they would be liable for prosecution for pecuniary penalties under s. 80 and damages under s. 82. The issue is beyond this dissertation's scope, but there appears no reason why ss. 80 and 82 should not cover lawyers.

148 I am grateful to Douglas White Q.C. for alerting me to this issue.

149 Calvani, Nonprice Predation in the Context of Regulatory and Adjudicatory Abuse in *THE CUTTING EDGE OF ANTITRUST. EXCLUSIONARY PRACTICES* (American Bar Association Section of Antitrust, Law Conference, Washington DC, October 5-6, 1989).

Cost-justified Test:

Judge Posner favours a cost-justified test. In Grip-Pak¹⁵⁰ his Honour observed: "Many claims not wholly groundless would never be sued on for their own sake; the stakes, discounted by the probability of winning would be too low to repay the investment in litigation".¹⁵¹

Yet in some cases a plaintiff still brings these claims. The reason must be to harm rivals. Such claims are thus shams. Judge Frank Easterbrook embellished the Grip-Pak test in Premier Electrical Construction Co. v National Electrical Contractors Association, Inc.¹⁵² as follows:

"If the expected value of a judgement is \$10,000.00 (say a 10 per cent chance of recovering \$100,000.00) the case is not "groundless" yet if it costs \$30,000.00 to litigate no rational plaintiff will do so unless he anticipates some other source of benefit. If the other benefit is the costs litigation will impose on a rival allowing an elevation of the market price, it may be treated as a sham".¹⁵³

A common criticism is that the test condemns harmless and valid behaviour. Areeda and Hovenkamp say that it means a dominant firm may not be able to collect a debt from a competitor as much debt collection is unprofitable.¹⁵⁴ A firm does such debt collection to deter potential debtors from not paying. Calkins notes that the test ignores that a firm may have good reasons for bringing a non-cost-justified suit. "A reasonable firm might bring a

150 Supra, note 109.

151 Id. at 472.

152 814 F. 2d 358 (7th Cir. 1987).

153 Id. at 372.

154. AREEDA & HOVENKAMP, supra, note 140, at 25.

meritorious trademark suit to establish the validity of its claim or to demonstrate its resolve to enforce its rights even though that particular suit would not be profitable".¹⁵⁵

Premier Electrical covers this. Judge Easterbrook acknowledges that non-cost-justified litigation has benefits. Premier Electrical only condemns non-cost-justified litigation where the benefit is the costs litigation will impose on a rival. "The plaintiff will be liable only if the other benefit is the costs litigation will impose on a rival".¹⁵⁶ If the other benefit is, for example, to establish a trademark's validity, there is no sham. If the other benefit is economically rational, there is no sham.

Areeda and Hovenkamp's example of debt collection is misplaced. Simple debt collection will not form the basis of a predatory litigation case. A predator brings a sham suit for its anti-competitive effect; for example, to delay entry into a market or to divert managerial time and resources or to raise rivals' costs. Debt collection will not do this. Thus, a plaintiff could not establish that a debt-collecting dominant firm had an anti-competitive purpose, let alone had used its dominant position.

Hurwitz objects, arguing that it is virtually impossible to forecast either a suit's potential rewards or its costs and he notes that litigation may offer legitimate strategies and psychological benefits.¹⁵⁷ As mentioned above, Premier Electrical will not condemn litigation which offers legitimate strategic

155 Calkins, *supra*, note 141, at 366.

156 *Supra*, note 152, at 327.

157 Hurwitz, *supra*, note 8 at 107.

benefits. Hurwitz correctly notes that litigation may have psychological benefits. Many individuals seek vindication in court, regardless of the fact that it is not cost-justified. Such behaviour is economically irrational. While individuals act irrationally, dominant firms do not. Litigation's psychological benefits are irrelevant to a dominant firm.

Despite these criticism the Grip-Pak test is very relevant to a s. 36 inquiry. It is an objective standard: what would a hypothetical, reasonable, rational firm do? It meets the "use" requirement. It would only be rational for a dominant firm to use capital reserves to bring such claims.

The Grip-Pak test is also relevant in establishing the proscribed purposes. Why would a firm bring a case if it is going to lose money? The answer must be only to harm a competitor.

The real advantage of Grip-Pak and Premier Electrical is that they offer workable tests. They are the best way of ensuring New Zealand law does not become a quagmire.

Conclusion:

Abuse of judicial and administrative processes should and does fall within the range of conduct subject to control under s. 36. Doubters should remember that it is those Chicago School scholars who have long proclaimed that the phenomenon of predatory pricing is so rare as not to be worthy of serious antitrust attention that have been at the forefront of alerting the antitrust community to the dangers inherent in the abuse of judicial and administrative processes. It is significant that two of the key cases which articulate workable

tests are Grip-Pak and Premier Electrical, authored by Judges Posner and Easterbrook. Surely this demonstrates that the topic is not "intellectual mush".¹⁵⁸ The RRC is not directly applicable. However, one of the concerns with predatory litigation is that it raises rivals' costs. Consequently, it is relevant.

158 Bork believes that antitrust law influenced by political nonefficiency values is "intellectual mush" : Bork, Panel Discussion, Merger Enforcement and Practice, 50 ANTITRUST L.J., 233, 238.

CHAPTER XIII

POSSIBLE FUTURE APPLICATION OF THE RRC MODEL

Introduction:

Although only two U.S. Courts have applied the model¹ it is, as I argued in Chapter VIII, consistent with the leading U.S. Supreme Court case on monopolisation; Aspen Skiing Co. v Aspen Highlands Skiing Corp.² The U.S. courts may have to face the issue directly in relation to the computer software giant Microsoft.

The Federal Trade Commission had been investigating Microsoft for three years over alleged anticompetitive practices.³ It deadlocked twice about whether to institute proceedings. The U.S. Justice Department has now taken over the investigation. It is unknown whether it will institute proceedings. However, one of Microsoft's alleged violations is a classic RRC strategy.

Microsoft paid computer manufacturers a fee to make their machine compatible with its MS-DOS software programme. This meant the machines

1 Premier Electrical Construction Co. v National Electrical Contractors Association, Inc. 814 F. 2d 358 (7th Cir. 1987); U.S. v Western Electric Co. 767 F. Supp. 308 (D.D.C. 1991).

2 472 U.S. (1985).

3 The F.T.C.'s report is confidential. I have relied on Lewyn, Going After Microsoft, National Review 24 (1994) and newspaper reports. I have also benefited from conversations with Professor Robert Pitofsky of Georgetown University Law Centre. Professor Pitofsky is counsel for one of Microsoft's rivals, Novell.

were unavailable to Microsoft's main rival's, Novell, software programme, DR-DOS. Microsoft insisted on this, whether or not the machine used the MS-DOS programme or not.

This had the effect that many computer manufacturers could not afford to offer DR-DOS to their customers. They could not afford to pay for DR-DOS and MS-DOS.

This is a naked exclusionary contract under the RRC model. The input market is computers. Microsoft paid the computer manufacturers to exclude its rivals' programmes. It did so by offering deep discounts. This raised its rivals' costs as they had to offer the computer manufacturers more to obtain access to their computers. It is the Real Foreclosure scenario as Microsoft had apparently contracted with the vast majority of manufacturers. It is also possibly the Cartel Ringmaster and Frankenstein Monster scenarios. The computer manufacturers who did not sign with Microsoft could form a cartel and increase the price for access to their computers to Microsoft's rivals. From the newspaper reports, it seems clear that Microsoft's contracts undoubtedly raised its rivals' costs. They are naked exclusionary contracts as not every computer used Microsoft's programme. Thus, Microsoft in these cases was simply paying to exclude its rivals.

The output market is computer software. It seems clear that Microsoft has power over price. Very few rivals constrain its conduct. It has over 80 per cent of the market.⁴ There are no substitutes for its programme. It can prevent price from falling. It thus, appears it has breached the RRC model and has

4 New York Times, Saturday, August 21 (1993).

violated s. 2 of the Sherman Act.

This discussion is based on media reports. The Justice Department will not release information on current investigations. Thus, there may be information which counters the RRC model. Microsoft claim it is simply offering a package discount. These do not necessarily breach the antitrust laws.⁵ However, it appears Microsoft has run counter to the RRC model, despite its protestations. If it did raise its rivals' costs and gain power over price, a court should be able to infer an anticompetitive purpose. Should the Justice Department choose to institute proceedings the U.S. courts will have to deal and discuss the RRC model.

5 Payette, Package Discounts : Risks, Under the Antitrust Laws Against Tying and Monopolisation, 23 IDAHO L. REV., 255 (1986).

CHAPTER XIV

EXCLUSIVE DEALING

Introduction:

Exclusive dealing is a paradigm Raising Rivals' Costs scenario. I shall apply the model to a New Zealand case: Fisher & Paykel Limited v Commerce Commission.¹ Part II of this chapter will examine the economics behind exclusive dealing. It will discuss its pro and anticompetitive effects. Part III examines overseas case law. Part IV applies the RRC model to Fisher & Paykel and discusses whether the model is useful. It argues that had the Court used the model it would have reached the same decision. Part V responds to critics of the decision. It argues the High Court correctly decided the case. Thus, the model is useful. Part VI offers some conclusions. Although, Fisher & Paykel did not involve s. 36, it is important. It is the best New Zealand case for assessing the model.

Economics of Exclusive Dealing:

Exclusive dealing occurs when one firm agrees to buy only from another firm for the contract's duration. In some contexts an exclusive dealing contract is known as a full supply contract. A requirements contract is a special type of exclusive dealing contract. Here, the buyer agrees to buy exclusively from the

1 [1990] 2 NZLR 731.

seller and the seller agrees to supply all of the buyer's needs for the product. Exclusive dealing has no effect on intrabrand competition. Intrabrand competition occurs between dealers of the same product. Exclusive dealing affects interbrand competition. This is competition between manufacturers and dealers of different products. Exclusive dealing can have both pro and anticompetitive effects. It is necessary to examine both:

A Procompetitive Consequences:

Suppliers wish to enter exclusive dealing contracts as they believe by using them, they can sell more of their goods. The following are the economic reasons for and the benefits of exclusive dealing.

1. Stimulate distributors:

By only dealing in one supplier's product, the distributor will promote that product more intensively and effectively than if it had numerous suppliers. Exclusive dealing secures the distributor's attention and effort to one brand. This is the most common reason put forward for exclusive dealing. The distributor, in Professor Richard Steuer's words, becomes an advocate for the product rather than simply a conduit.² By having distributors sell only its product, a supplier is likely to sell more of its product.

2. Protection of a supplier's property rights:

² Steuer, Exclusive Dealing in Distribution; 69 CORNELL L. REV. 101, 125 (1983).

Professor Geoffrey Walker, in a seminal article, first brought this reason to the antitrust world's attention.³ At virtually the same time, Professor Howard Marvel provided a similar analysis.⁴ The thrust of the argument is as follows: a supplier wishes to sell as much of its product as possible. To do so, it provides the distributor with special services. These include: advertising, technical and sales training, management systems, start up capital, architectural plans, site selection, merchandising plans, facilities to demonstrate the product, product design and after sales service, including repairs.⁵ These services make the distributor more effective in selling the supplier's products. They also create more sales for the distributor. They also cost. Generally, the supplier charges the cost of these services by incorporating them into the wholesale price. However, this can cause a problem if the distributor sells products for a supplier's competitors. The competitors may not supply these services. Therefore, their price will not be as expensive, or if they are, they will offer the distributor a larger margin. The services the supplier provides, may attract customers into the distributor's shop. The distributor takes advantage of the services and persuades the customer to buy a substitute product - which is either cheaper or offers the distributor a higher margin. The substitution does not harm the distributor's reputation and sales and the distributor's margin increases.

3 Walker, Exclusive Dealing and Property Rights, 53 ALJ 70 (1979).

4 Marvel, Exclusive Dealing, 25 J.L. & ECON. 1 (1982).

5 See Steuer, *supra*, note 2, at 127; Ornstein, Exclusive Dealing and Antitrust, 34 Antitrust Bull. 65 at 75 (1989) Strasser, Antitrust Policy in Agreements for Distribution Exclusivity, 16 CONN L. REV., 969, 978-981 (1984).

Exclusive dealing protects the supplier's property right and the services it provides, by preventing the distributor taking a free ride on the supplier's services and investments. It prevents distributors from using the supplier's investments to promote the supplier's rivals' products. Similarly, it prevents competitors who have not provided the services, from using the distributor and taking a free ride. If competitors and distributors can free ride, the supplier is less likely to provide these services. Indeed, a supplier will only do so, in the absence of exclusive dealing, if it is assured of complete distributor loyalty. The services attract customers, and exclusive dealing ultimately allows for greater consumption than normal.

Commentators have recognised a number of qualifications to this hypothesis. In relation to advertising; there must be sufficient economies of scale for the supplier to advertise, rather than the distributor.⁶ It must be relatively easy and cheap for a distributor to encourage a customer to switch product.⁷ The advertising must be general in nature and not brand specific.⁸

The hypothesis only applies to shopping products; i.e. products for which customers shop around before buying.⁹ It is especially relevant for products in which there are repeat purchases. Some customers will return to the distributor where they originally purchased. The exclusive dealing helps the supplier get a

6 J.S. Chard, Economic Effects of Exclusive Purchasing Agreements in the Distribution of Goods, in MARKETING CHANNELS 39, 40-41 (L. Pellegrini and S.K. Reddy eds., 1986).

7 *Id.* at 41.

8 *Ibid.*

9 *Ibid.* Steuer, *supra*, note 2, at 121.

return on the capital it spent to obtain the customer originally.

Reputation is another property right a supplier can protect through exclusive dealing. A supplier will invest and create a uniform reputation among distributors, if it can capture the value of that reputation.¹⁰ It will not do so if its competitors can free ride and share the benefits of its investment. Professor Gregory Frasco notes exclusive dealing is not the only way of solving the problem and protecting a supplier's property rights.¹¹ An alternative is to charge the supplier's competitors or the distributors for the benefits they receive.¹² For example, the supplier could demand a percentage of all sales revenue or a lump sum fee from the distributor for all brands the distributor sells which benefit the supplier's investment. The problem with this, is it is likely to lead to huge and expensive administrative problems. If the distributor pays a royalty system, it has the incentive to misreport sales. Such a system will also be very expensive to monitor.

3. Encourage suppliers to invest in special services:

Closely linked, if not identical to the above reason, is the reason to encourage suppliers to provide special services. The special services are outlined above. The British Monopolies Commission, when it investigated petrol supply,

10 Chard, *supra* note 6, at 45-53; L. Shishido-Topel, An Economic Analysis of Exclusive Dealing (1984) (unpublished Ph.D. dissertation, University of California (Los Angeles) 40-44).

11 G. FRASCO, EXCLUSIVE DEALING, A COMPREHENSIVE CASE STUDY 6-7 (1991).

12 *Id.* at 7.

found exclusive dealing between the oil companies and petrol stations had resulted in improvements in the layout of petrol stations, and the facilities the stations provided and the service they gave.¹³ As Professor John Chard notes: "[A]rguably these improvements would not have been realised to the same extent without capital investment in the retail trade by oil companies ... and without the trading facilities and advice offered to retailers by the companies".¹⁴

4. Reduce costs and business uncertainties:

Exclusive dealing may reduce the costs of distribution for both suppliers and distributors and protect them from business uncertainties.¹⁵ Exclusive dealing may enable the supplier and distributor to engage in long-term planning. The distributor has an assured source of supply. This is important in periods of fluctuating demand, as it helps eliminate the costs of selling and buying. Suppliers with an assured distributor can have smaller product runs. Another cost saving is that it decreases the number of distributors the supplier has to deal with. The U.S. Supreme Court in Standard Oil Co. of California v U.S.¹⁶

13 BRITISH MONOPOLIES COMMISSION, SUPPLY OF PETROL TO RETAILERS IN THE UNITED KINGDOM 264 (1965).

14 Chard, *supra*, note 71, at 43-44.

15 G. FRASCO, *supra*, note 11, at 6-7; Strasser, *supra*, note 5, at 977; Kattan, An Outline of the Economic Effects of Vertical Restraints (1993) (ABA Section of Antitrust Law, Antitrust Fundamentals Programme 17-28); V. KORAH and W.A. ROTHNIE, EXCLUSIVE DISTRIBUTION AND THE EEC COMPETITION RULES 29-30 (2d ed. 1992); Shishido-Topel, *supra* note 10, at 37-39; E.T. SULLIVAN and J.L. HARRISON, UNDERSTANDING ANTITRUST AND ITS ECONOMIC IMPLICATIONS 178-179 (1988).

16 337 U.S. 293 (1949).

recognised this. Justice Frankfurter noted exclusive dealing may assure a steady supply, give protection against increases in demand, enable long-term planning on the basis of known costs and obviate the expenses and storage, in the quantity necessary, for a product having a fluctuating demand.¹⁷ Exclusive dealing can also lead to lower input costs for suppliers. Small buffer inventories are necessary and the parties can share them among themselves. These cost savings may well help a new entrant into the market.¹⁸

Exclusive dealing can also lead to greater exchange of information. Not only between suppliers and distributors, but also, between the distributors themselves. The problems and solutions a distributor encounters, may be used by all. The information is more likely to be exchanged, if it is not going to be used to sell competitors' products. Similarly, a supplier is likely to provide management assistance if the distributor only sells its products. In this way, the entire distribution systems act as one and they become more efficient. The whole system can run more generally, and efficiently respond to supply and demand variations.¹⁹ Thus, exclusive dealing helps decrease the cost of moving a product from the supplier to the distributor to the consumer.

5. Protect the product's quality and reputation:

Exclusive dealing may ensure a supplier's products' quality and reputation.

17 Id. at 306.

18 P. AREEDA and L.A. KAPLOW, *ANTITRUST ANALYSIS PROBLEMS TEXT AND CASES* 773-777 (4th ed. 1988).

19 Strasser, *supra*, note 5, at 972-974.

Chard notes that a product's quality varies with its safety, durability, and reliability.²⁰ A product's quality may be difficult to inspect on purchase. It may only be discernable after purchase. A supplier will consider that after-sales services are important in ensuring the product's quality. If a product goes wrong after purchase, a customer may have difficulty in deciding who was at fault - the distributor or supplier. The distributor could cut back on pre and post sales servicing of the product, and the customer may blame the supplier. This can impair the supplier's product's reputation and/or harm sales by other distributors. Thus, the supplier could insist on exclusive dealing. This enables the supplier to monitor the distributor and ensure the distributor services the product adequately. A distributor who has an exclusive dealing contract and who is subject to being terminated if it provides inadequate servicing, may be induced to provide a greater supply of services. In its report on the LPG industry, the British Monopolies Commission found that exclusive dealing probably improved safety, as it enabled suppliers to 'better control their distributor's storage and handling of LPG cylinders. The LPG cylinders' safety and reputation for safety were important to suppliers. Suppliers did not want their cylinders to be associated with cylinders from rival suppliers, whose safety standards were not as high as their own.²¹

Chard notes the following conditions are necessary for this hypothesis to

20 Chard, *supra*, note 5, at 45.

21 BRITISH MONOPOLIES COMMISSION, *SUPPLY OF LIQUIFIED PETROLEUM GAS*, 147 (1981).

be valid and effective.²²

1. The distributor must be able to influence a products' quality.
2. The consumer must be able to perceive differences between different products.
3. The consumer cannot ascertain quality before he or she buys. Also, brand names must help the consumer ascertain quality.
4. It is more effective for the supplier's brand name to be used as a signal for quality than the distributor's. If consumers rely on distributors to signal quality, the supplier does not need to control the distributor's behaviour.

There are other ways in which exclusive dealing can help maintain quality. If a distributor carries many brands, it may substitute (by mistake or not) one supplier's part into another supplier's product. This can decrease reputation and safety.²³ Chard gives the example of LPG cylinder consumers fitting inappropriate cylinders to their gas appliances. Suppliers could insist on their distributors undertaking strict operating procedures to prevent this. However, exclusive dealing is cheaper.²⁴ Not only safety is at issue, but also reliability.²⁵ As mentioned above, a distributor may under-invest in pre and post sale services that affect quality. A distributor may also free ride on services a supplier provides for another distributor. Chard gives the example of Raleigh Industries

22 Chard, *supra*, note 5, at 46-47.

23 *Id.* at 47-48.

24 *Id.* at 48.

25 *Id.* at 48-50.

and the investigation by the British Monopolies Commission in bicycles.²⁶ Raleigh claimed it used exclusive dealing to protect its investment in pre and post sales services. These investments maintained its reputation for quality. The Commission agreed in relation to spare parts, there is less scope for confusion, and placing the spare part of one product into another with exclusive dealing.²⁷ Exclusive dealing may decrease confusion and maintain the supplier's reputation. The whole distribution system suffers if one supplier lets quality slip. The only person who may benefit is the distributor who lets it slip.

6. The keeping of trade secrets:

Steyer notes that exclusive dealing can help a supplier keep trade secrets and other confidential information from competitors.²⁸

7. Prevention of opportunistic behaviour over specialised investments:

Professors Benjamin Klein, David Crawford and Michael Alchian argue exclusive dealing prevents opportunistic behaviour by users of specialised assets or investments.²⁹ An investment is specialised if its value is highly specific to a particular firm. Its next best use is less than its value to the particular firm. These specialised investments include:

- (a) machinery made for a particular firm's business,

26 Id. at 49.

27 Id. at 50-53.

28 Steuer, *supra*, note 2, at 130.

29 Klein, Crawford & Alchian, Vertical Integration, Appropriable Assets and the Competitive Contracting Process 21, J.L. & ECON. 297 (1978); Ornstein, *supra*, note 5, at 71; FRASCO, *supra*, note 11, at 7.

- (b) locating refining facilities for a raw material near extraction operations.

A firm may make specialised investments in another firm. The other firm may threaten to contract with a third party, unless the firm which has made this specialised investment accepts the value of the specialised investment at its next best use, or at a quantity just enough to cover variable costs (i.e. its opportunity costs) - whichever is the greatest. Exclusive dealing prevents this, and protects specialised investments. These specialised investments may also result in cost savings.

Klein et al. give the example of General Motors and Fisher.³⁰ G.M. hired Fisher to make car bodies. Fisher had to invest in G.M. specific car bodies. Once Fisher had invested, G.M. could decrease its purchase price to Fisher's opportunity costs in making car bodies. As the bodies were specific to G.M., this would be very low. To prevent this, Fisher required G.M. to enter into an exclusive dealing contract with it (i.e. buy its car bodies only from it). The exclusive dealing contract eliminated G.M.'s alternative, and prevented G.M. from buying bodies from anyone else if Fisher didn't lower its price once it made the bodies.

8. Alternative efficiency explanation:

Doctor Lynn Shishido-Topel has developed an alternative explanation for exclusive dealing. She claims her explanation shows how exclusive dealing enhances efficiency.³¹ She analyses exclusive dealing under the model of the

30 Klein, Crawford & Alchian, *supra*, note 29, at 309-310.

31 Shishido-Topel, *supra*, note 10, at 45-48.

supplier as principal and the distributor as the supplier's agent. She says that in normal principal agent relationships, the principal is unable to monitor its agents' efforts perfectly. The principal hopes its agent will act, so as to maximise the total income of the principal and agent. As the principal cannot perfectly monitor the agent, the agent can provide less service than it contracted to provide. This can occur more often, when the agent deals with more than one principal's product. As mentioned above, if the agent does this, it can affect the principal's product quality. This affects the principal's sales and reputation. It would also seem to affect the agents' sales as well. Shishido-Topel argues the agent will find the skimping of services beneficial, as the principal cannot perfectly monitor it, and it could spread the costs of it so acting over other agents. For example, an agent who skimps will decrease sales of the principal's product, but will still benefit, if other agents share the decrease in sales of the principal's product. Product quality and consumption will fall below socially optimal levels. Exclusive dealing enables better monitoring and thus, means agents will more likely provide the services at the socially optimal level and protect product quality. Shishido-Topel argues that paying an agent to provide the optimum level of services is not as good as exclusive dealing. It is administratively expensive. She empirically tests her hypothesis by analyzing three cases, and finds her explanation was the reason for exclusive dealing in those cases.³²

32 Id. at 66-150, She analyses: FTC v Adolph Coors Co. 83 F.T.C. 32 (1973); FTC v Harley Davidson Motor Co. 50 F.T.C. 1047 (1954) and F.T.C. v Motion Pictures Advertising Co. 334 U.S. 392 (1953).

9. Lower prices:

As mentioned above, exclusive dealing can lead to improved efficiency in the distribution of products. This is a form of productive efficiency. The supplier chooses exclusive dealing because it allows cost savings and improvement of quality at a lower cost than would be the case without exclusive dealing. The supplier passes these efficiencies on to consumers as lower prices. This is especially so with small towns with only one or few retail shops. Retailers in these small towns are monopolies and can charge consumers a monopoly price. To get these retailers to enter into exclusive dealing contracts, suppliers must offer these retailers something extra. The something extra is lower prices. Economic theory suggests retailers will pass some of these lower prices on to consumers.³³

10. Helping small suppliers:

Exclusive dealing may help new market entrants become established. As mentioned above, exclusive dealing can stimulate distributors to greater efforts in selling a supplier's product.³⁴ This is especially worthy when a new entrant faces established suppliers. Exclusive dealing can also lead to the preservation and deconcentration of markets.³⁵ It may also stop concentration in markets where large firms are expanding.

33 R.H. BORK, *THE ANTITRUST PARADOX: A POLICY AT WAR WITH ITSELF* 307 (2d ed. 1993).

34 AREEDA & KAPLOW, *supra*, note 18, at 773-777.

35 S.F. ROSS, *PRINCIPLES OF ANTITRUST LAW* 331 (1993).

Professor Stephen Ross gives the example of beer distribution in the U.S. and the Netherlands, as compared to the U.K. and Germany.³⁶ In the U.S. and the Netherlands, pubs sell all varieties of beers. In the U.K. and Germany pubs often sell only one brand of beer. A few major breweries dominate the U.S., while the Netherlands has only two. In the U.K. and Germany, numerous breweries compete. The reason may be that in the U.K. and Germany, where brewers have exclusive dealing contracts with pubs, the pubs compete on quality and promote brand loyalty. Whereas in the U.S. and Netherlands, the lack of exclusive dealing leads to price competition which large firms that have economies of scale and production or distribution can take advantage of.

11. Greater consumer choice:

It may seem paradoxical to argue that exclusive dealing leads to greater consumer choice. The argument runs as follows:

To become established a new supplier, who hopes to enter will have to develop its own distributors. Once it has done so, consumers will not only have a choice of products, but they will also have a choice of distributors. This leads, not only to increased supplier competition, but also increased distributor competition. Distributors will compete more fiercely if they only carry one brand.³⁷

36 Id. at 312.

37 Director of Investigation and Research v Bombardier Ltd (1980) 53 CPR (2d) 47 at 60-61.

B. Anticompetitive Effects:**1. Foreclosure:**

The primary anticompetitive concern over exclusive dealing is foreclosure. Exclusive dealing may foreclose the access of a supplier's rivals and potential rivals to distributors. Thus, the rival suppliers cannot find distributors for their products. However, the trouble with this argument is that every supply contract excludes competitors in the sense that competitors cannot carry out the transactions which the supply contract specifies.³⁸ Not every exclusive dealing contract will lead to anticompetitive foreclosure. One must consider a number of factors to determine whether exclusive dealing effectively forecloses competitors.

(a) Alternative methods of suppliers distributing products:³⁹

This is the most important factor. For exclusive dealing to be anticompetitive, rival suppliers cannot have alternative methods of distributing their product, i.e. the elasticity of supply from alternative sources must be low (inelastic). If suppliers can distribute their products in other ways, the anticompetitive foreclosure of exclusive dealing decreases. A supplier may be able to find alternative methods of distribution in a number of ways. It can use distributors who have never sold the product before. It can establish new distributors. It can use new methods of distribution, such as mail drops or door-

38 Strasser, *supra*, note 5, at 985.

39 Steuer, *supra*, note 2, at 123-124.

to-door selling.⁴⁰

(b) Size of supplier:

Exclusive dealing is more likely to lead to effective foreclosure if the supplier using it, has a large market share. The larger the share, the more distributors it can tie into exclusive dealing. Professor Oliver Williamson believes exclusive dealing can only be anticompetitive in the case of structural dominance, or in a tight oligopoly.⁴¹ He defines structural dominance in a market as where the market share of the dominant firm is at least 60 per cent and market entry is not easy.⁴²

(c) Number and nature of distributors the exclusive dealing covers:

The larger the number of distributors the exclusive dealing covers, the more likely foreclosure is to be anticompetitive. This is especially so, if the distributor is a monopolist. However, Steuer notes the simple percentage of distributors foreclosed is not an adequate means of assessing anticompetitive effect.⁴³ One has to measure the percentage of sales those distributors accounted for. That an exclusive dealing contract forecloses 25 per cent of

40 Id. at 123.

41 Williamson, Assessing Vertical Market Restrictions: Antitrust Ramifications of the Transaction Cost Approach, 127 4 U. PA. L. REV. 953, 965 (1979).

42 Williamson, The Vertical Integration of Production: Market Failure Considerations, 61 AM. ECON. REV., 112, 234-247 (1977).

43 Steuer, *supra*, note 2, at 117.

distributors does not, necessarily, mean that rival suppliers are foreclosed from reaching 25 per cent of consumers. The foreclosed distributors may not have had 25 per cent of sales. It may be more or less. Sales percentage alone is not enough. One has to take account of consumer loyalty to the distributor.⁴⁴ Some distributors have more consumer loyalty than others. Consumers will stay with these distributors if they switch to another supplier's product via exclusive dealing. Thus, exclusive dealing is likely to foreclose these distributors.

Closely related to loyalty is the effectiveness of the distributors foreclosed.⁴⁵ Some distributors are more effective than others. If the supplier enters into an exclusive dealing contract with these, the distributors left for rival suppliers will be lower quality and less effective. Thus, foreclosure will be greater.

One has to consider whether the distributor is a wholesaler or retailer.⁴⁶ Retailers have more consumer loyalty than wholesalers. Foreclosure will be more effective if retailers are subject to exclusive dealing than wholesalers.

(d) Prevalence of exclusive dealing in the market:

Exclusive dealing is more likely to lead to anticompetitive foreclosure, if the industry concerned has a trend to exclusive dealing.⁴⁷ This is especially so, if the supplier level is tightly concentrated and all suppliers use exclusive dealing.

44 Id., at 118-119.

45 Id., at 119.

46 Id., at 118-120.

47 Strasser, *supra*, note 5, at 985-986.

(e) Type of product:

Economists divide products into shopping products and convenience products.⁴⁸ With shopping products, consumers shop around before they buy. They compare different brands and prices before buying. If a distributor has only one brand, consumers will look elsewhere before buying. Foreclosure of distributors is not likely to be effective if shopping products are involved.

Convenience products are products which consumers buy where they first find them, without comparing price or other brands. They do so, either because they are perishable or cheap. Exclusive dealing in these products is more likely to result in anticompetitive exclusion.

(f) Length of the exclusive dealing agreement:⁴⁹

The longer the exclusive dealing agreement, the more effective foreclosure will be. However, short agreements can result in effective foreclosure if other suppliers have no alternative ways of distributing their products.⁵⁰

(g) Presence of economies of scale:

Shishido-Topel has noted that: "[e]conomies of scale and distribution or supply together with rivals having sufficient demand to support outlets alone can allow exclusive dealing to become a relatively reasonable way of foreclosing

48 Steuer, *supra*, note 2, at 121-123.

49 Strasser, *supra*, note 5, at 985.

50 Bok, The Tampa Electric Case, SUP. CT. REV. 267, 272 (1961).

competitors".⁵¹

Professor F.M. Scherer has argued:

"[t]he automobile industry provides the clearest example of this last case. There are moderate economies of scale in retailing. Established brands are able to have a good sized exclusive dealership even in relatively small towns and the opportunity to sell a well accepted make is attractive to would be dealers. Therefore, the largest producers have first pick among candidates and can engage the most able ones. This in turn gives G.M. and Ford a lasting product differentiation advantage, for auto buyers flock in disproportionate numbers to the authorised parts and service in both large and small cities. This may influence the car purchase decisions of mobile customers. Lack of an extensive first rate sales and services network is one of the reasons by Studebaker-Packard was forced to discontinue passenger automobile production, why foreign cars have a difficult time penetrating the U.S. market and why A.M. and to a lesser degree Chrysler have not found it easy to build up and sustain their sales volume stock. Before formal and informal pressures toward exclusive dealing in automobiles could be eliminated and if a sufficient number of dealers were willing to take on additional makes, the growth of competition from smaller and foreign automobile producers would be greatly stimulated".⁵²

The foreclosure effect will only be long lasting if there are substantial economies in production.⁵³ If not, rival suppliers can sell first in larger markets. If they are successful there, their product will then penetrate smaller towns. The excluded suppliers may be able to defeat the foreclosure effect due to economies of scale by banding together, to take advantage of scales in retaining, and selling their products together in alternative outlets.

Scherer's concern about the inability of foreign automobiles to enter the

51 Shishido-Topel, *supra*, note 10, at 31.

52 F.M. SCHERER, *INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE*, 586 (2d ed. 1980).

53 B.P. PASHIGAN, *THE DISTRIBUTION OF AUTOMOBILES: AN ECONOMIC ANALYSIS OF THE FRANCHISE SYSTEM*, 219 (1961).

U.S. market has been well overtaken by the events of history and the success of the Japanese.

Thus, many factors contribute to whether an exclusive dealing contract leads to foreclosure. One has to analyse each exclusive dealing contract on a case by case basis. However, it seems exclusive dealing will never lead to truly effective foreclosure as: Foreclosure of distributors will lead to an increase in demand for distributors which will attract new entrants. The presence of monopoly profits at distributor and/or supplier levels will similarly lead to new entrants. Some Chicago School commentators believe exclusive dealing has no anticompetitive effects at all and that foreclosure is not worthy of concern. If a supplier lacks market power, it has to offer the distributor something in return for the distributor agreeing not to handle rival suppliers' products. The something more, is likely to be that the supplier will supply the product at a lower cost.⁵⁴ Distributors can transfer this to consumers at lower price. Everyone seems to agree with this, which is why Professor Williamson says exclusive dealing is only harmful in the case of structural dominance or tight oligopoly.

The Chicago School commentators argue that even if the supplier has market power, exclusive dealing presents no concern. The monopoly power (i.e. the ability to charge supra competitive prices) a supplier has is limited. It can use it by asking more for its product or asking for something else. For example, an exclusive dealing agreement. Thus, a supplier can only exploit its market power to a certain degree. If a supplier demands exclusive dealing, it cannot be

54 BORK, *supra*, note 33, at 307.

motivated simply by its desire to charge higher prices because it can charge the profit maximising price by its direct use of market power.⁵⁵ It asks for an exclusive dealing contract to achieve efficiencies and thus lead to greater sales.

The weakness in this argument is that a supplier can use exclusive dealing to engage in strategic behaviour. This is behaviour, designed to decrease the attractiveness of a rival's products. Exclusive dealing can raise entry barriers by raising rivals' costs.

2. Entry barriers and raising rivals' costs:

Exclusive dealing can raise entry barriers to rival and potential rival suppliers.⁵⁶ The factors that are relevant in assessing foreclosure effects, are relevant in assessing whether exclusive dealing raises entry barriers. While as mentioned above, exclusive dealing may not achieve truly effective foreclosure, it can raise entry barriers. It does so by raising rival's costs. It can force new entrants, at either the supplier or distributor level, to compete at both levels, i.e. force new entrants to become vertically integrated. This is likely to be prohibitively expensive. Indeed, it was dissatisfaction with the simple foreclosure model that led Salop et al. to devise the RRC model.

3. Reducing the demand rival suppliers and distributors face:

Frasco argues that incumbent distributors and suppliers can use exclusive

55 Ibid.

56 Strasser, *supra*, note 5, at 984-990.

dealing to reduce the demand for their rivals' products.⁵⁷ This is anticompetitive because, if a firm succeeds in decreasing the demand for its rivals' product, then the demand for the firm's product (in the absence of new entry) will increase, as well as its capacity to earn profits.

Frasco argues it can do this by its exclusive dealing contracts having staggered expiry dates. He uses two related models to show this. The first model has the following assumptions in the case of a potential entrant:

- (1) There are a number of existing exclusive dealing contracts between upstream and downstream producers.
- (2) The exclusive dealing contracts have different expiry dates.
- (3) Producing the product subject to exclusive dealing, entails a range of increasing returns to scale.
- (4) Entering the market at supplier and distributor level is prohibitively expensive, compared to entry at one level.

From assumptions one and two, a potential entrant only has part of the market demand available when it chooses to enter. The structure of the model forces losses upon new entrants for a certain number of time periods (corresponding to the expiration of the exclusive dealing clauses) after entry. The existing distributors and suppliers establish the expiry date of the exclusive dealing clauses so as to hinder entry, to whatever extent maximises their own present value.⁵⁸

57 G. Frasco, *Exclusive Dealing and Entry Deterrence* (1986) (unpublished working paper, Cornell University).

58 *Ibid.*

In the second model, assumptions one, two and three remain, but four goes. Frasco shows that the existing suppliers can give the existing distributors the incentive to stop from decreasing quantity of output even if entry at both supplier and distributor were to occur. The existing suppliers do so by structuring the charge for their products to suppliers such as to leave distributors with a suitable low average variable cost. Suppliers do so by dividing the charge for the product into two components, one a relatively low per unit price and two a relatively high lump sum. Knowing that existing distributors will not decrease their output discourages entry.⁵⁹

Matthewson and Winter argue exclusive dealing can decrease demand in the case where the market can profitably support more than one brand of product, but where one brand is much more popular than others. If distributors have the choice of selling the popular brand exclusively or selling all brands, the distributors may choose to do the former as they see it being more profitable. Thus, suppliers of the popular brand could use exclusive dealing as a way of keeping rival brands off the market, thus decreasing their demand.⁶⁰

4. Price Discrimination:

Exclusive dealing may lead to price discrimination. Professor Lester Telser notes that: "[e]xclusive dealing may be a necessary adjunct of a price

59 G. Frasco, *Exclusive Dealing and Entry Deterrence: The Case of Vertically Integrated Entry* (1986) (unpublished working paper, Cornell University); Frasco, *supra*, note 11, at 24-25).

60 G. Mathewson and R. Winter, *Is Exclusive Dealing Anticompetitive?* (1985) (unpublished working paper, University of Toronto).

discrimination scheme".⁶¹

Some consumers may value a product more than others and thus be prepared to pay a higher price for it. That product may have two uses. Its use in a competitive market, or it can be substituted for a second product in a less competitive market. The supplier may therefore wish to charge a price above marginal cost for use of the product in its first use, but below its marginal cost in its second use in the less competitive market. The supplier price discriminates amongst different classes of consumer for the second use. This would not work if consumers could buy the first product from other sources, or if the supplier did not have a monopoly in this second market.⁶² Thus, exclusive dealing can exploit but not create market power. Whether this is anticompetitive depends on how one views price discrimination.⁶³

5. Increased collusion:

Commentators believe that exclusive dealing can lead to collusion at either supplier or distributor levels.⁶⁴ They argue that widespread exclusive dealing amongst suppliers limits the number of distributors, which makes collusion easier because of the fewer numbers. Fewer numbers makes it easier

61 L. Telser, Abusive Trade Practices; 36 LAW & CONTEMP. PROBS. 488, 491 (1963).

62 Shishido-Topel, *supra*, note 10, at 36.

63 Telser argues price discrimination may increase social output. Telser, *supra*, note 61, at 489.

64 Strasser, *supra*, note 5, at 991; MacCrimmon and Sadanand, Models of Market Behaviour and Competition Law: Exclusive Dealing, OSGOODE HALL L.J. 709, 739 (1989).

to detect cheating by lower prices. Strasser comments exclusive dealing alone, does not seem likely to establish a supplier cartel or interdependent pricing.⁶⁵ Suppliers who have exclusive dealing contracts with their distributors have a partial indirect influence over price. The supplier sets a wholesale price which can have some influence on the retail price the distributor sets. The collusion is made more possible by two other characteristics of exclusive dealing:

1. If a supplier increases its wholesale price, the distributor cannot easily switch to other suppliers of the product.
2. The exclusive dealing as a restraint can lead to fewer competitors, which can decrease the likelihood of price competition and making cheating more detectable.

Strasser notes that these characteristics are not overwhelming but they can increase the potential for exclusive by collusion.⁶⁶

Exclusive dealing and resale price managements together are more likely to help collusion.⁶⁷ Exclusive dealing makes it difficult for distributors to change suppliers. The resale price maintenance lowers the probability of price cutting by making it more easy to detect. Some commentators see the relationship between exclusive dealing and resale price maintenance as a quid pro quo one. The suppliers decrease current price competition in the distributor's market by resale price maintenance in return for providing a more

65 Strasser, *supra*, notes, at 991.

66 *Ibid.*

67 Telser, Why Should Manufacturers Want Fair Trade? 3 J. L. & ECON. 86, 97 (1960).

secure market by exclusive dealing.⁶⁸ The resale price maintenance prevents the distributors from price cutting to increase sales. This decreases the supplier's incentive to decrease wholesale price. Exclusive dealing prevents suppliers from trying to obtain special treatment from distributors over other distributors via secret price cuts. The exclusive dealing also stops suppliers attracting distributors from other suppliers via secret price cuts. The exclusive dealing thus, increases the probability of detecting cheating.⁶⁹ How great a threat this all is is questionable, as certain conditions have to apply for a durable cartel and it appears that exclusive dealing with resale price maintenance is the exceptional rather than the usual resale price maintenance situation.⁷⁰ Telser argues: "[B]oth practices are needed to make effective collusion among the suppliers".⁷¹

6. Decreasing consumer choice:

Exclusive dealing arguably decreases consumer choice by making comparison shopping more difficult. Consumers who wish to compare brands and see whether price differences are justified cannot make a considered

68 B. YAMEY, THE ECONOMICS OF RESALE PRICE MAINTENANCE 19-21 AND 343-353 (1954); Bowman, The prerequisites and Effects of Resale Price Maintenance, 22 U. CHI. L. REV. 825, 838-839 and 844-848 (1955). Shishido-Topel, *supra*, note 10, at 34-35.

69 G.J. STIGLER, THE THEORY OF PRICE 230-236 (3d ed. 1966).

70 Posner, The Rule of Reason and the Economic Approach: Reflections on the Sylvania Decision 45 U. CHI. L. REV. 1, 7 (1977).

71 Telser, *supra*, note 67, at 10.

decision as easily, if exclusive dealing exists.⁷² This is more so, if the consumer has only one distributor in his or her town. However, if the product is a shopping product, the consumer is more likely to go into other centres where the choice is available. The decrease in choice for small town consumers has to be traded off against the exclusive dealing allowing lower prices.⁷³

7. Increased price for some consumers:

Exclusive dealing, as mentioned above, leads to suppliers supplying special services to distributors. These may initially increase the cost of the product. However, they can lead to greater sales, which results in ultimately cheaper prices. However, not every consumer values these special services.⁷⁴ Consumers who want the product without these special services cannot buy it. Exclusive dealing means the product comes with these special services or not at all. Bork argues that the: "[t]echnology distribution ... [does] not allow the preferences of both groups of customers to be met, [i.e. those who value services and those who do not]... a manufacturer will choose to satisfy the largest number.⁷⁵ This is the efficient thing to do.

72 Strasser, *supra*, Note 5, at 992; Ahdar, Exclusive Dealing and the Fisher and Paykel Saga, 15 NZULR 1, 12-13 (1992).

73 See text accompanying notes 34-37 *supra*.

74 Comanor and Frech, The Competitive Effects of Vertical Agreements?, 75 AM. ECON. REV. 539 (1985); Comanor, Vertical Price-Fixing, Vertical Market Restrictions, and the New Antitrust Policy, 98 HARV. L. REV. 983, 991-1000 (1985); Ahdar, *supra*, note 72, at 13-14.

75 Bork, Vertical Restraints:Schwinn Overruled, 1977 SUP. CT. REV. 171, 181 (1978).

Thus, exclusive dealing has both pro and anticompetitive effects. The general economic view is that its advantages outweigh the negatives and the anticompetitive effects only exist in certain conditions. I now turn to the overseas law on exclusive dealing.

LEGAL TREATMENT:

United States Law:

Three statutes govern exclusive dealing in the U.S. Section 3 of the Clayton prohibits exclusive dealing where such arrangements effect: "may be to substantially lessen competition or tend to create a monopoly in any line of commerce".⁷⁶ Section 3 only applies to "goods, wares, merchandise, machinery and supplies of other commodities".⁷⁷ Section 1 of the Sherman Act⁷⁸ and Section 5 of the Federal Trade Commission Act⁷⁹ cover exclusive dealing which does not fall within the Clayton Act. The Sherman Act prohibits exclusive dealing when it restrains trade. The Section 3 and Section 1 standards are identical.⁸⁰ Section 5 of the Federal Trade Commission Act prohibits exclusive dealing contracts if they are "unfair methods of competition".

76 15 U.S.C. 14 (1982).

77 Ibid.

78 15 U.S.C. 1 (1982).

79 15 U.S.C. 45 (1992).

80 ROSS, *supra*, note 35, at 304; Twin City Sportservice, Inc. v Finley 676 F. 2d 1291, 1302 (9th Cir. 1982), cert. denied 459 U.S. 1009 (1982).

Exclusive dealing's legal history has varied widely. Professor Milton Handler notes: "the law's treatment of exclusive dealing arrangements has had a long history marked by sharp swings of the pendulum from extreme positions both of legality and invalidity".⁸¹

Legal History:

Initially under both the Common Law and the Sherman Act, courts viewed exclusive dealing as benign.⁸² Congress enacted the Clayton Act and then the Federal Trade Commission Act, in part to counter this.⁸³ The first key Supreme Court case was Standard Fashion Co. v Magrane-Houston Co.⁸⁴

Standard manufactured dress patterns. Margrane-Houston ran a retail dry goods shop in Boston. Standard contracted with Margrane to supply patterns on the condition Margrane inter alia, did not sell any other patterns. Standard controlled 40 per cent of the 52,000 pattern agencies in the U.S. Standard and its three major competitors controlled 90 per cent of pattern agencies. Exclusive dealing contracts covered most agencies. Margrane breached the exclusive dealing contracts. Standard sued. The Supreme Court held the contract breached s. 3 of the Clayton Act and thus, the contracts were unenforceable.

81 Handler, Statement Before the Small Business Administration, Antitrust Bull. 417, 425 (1966).

82 Handler, supra, note 81, at 425; Robinson, Restraints on Trade and the Orderly Marketing of Goods, 45 CORN. L. QTRLY. 254, 275 (1960).

83 A.D. NEALE, THE ANTITRUST LAWS OF THE UNITED STATES OF AMERICA 178 (1970).

84 258 U.S. 346 (1922).

The Court found it relevant that Standard controlled 40 per cent of the market. It imposed a market dominance standard, which prohibited relatively large firms from using exclusive dealing. If they did, it would lead to market foreclosure. Subsequent Courts however, upheld exclusive dealing if the market share foreclosed was not sufficient to lessen competition.⁸⁵ They also took into account other economic factors.⁸⁶ Thus, the Courts employed a rule of reason approach and evaluated the competitive effects of exclusive dealing.⁸⁷

This changed in Standard Oil of California and Standard Station Incorporated v U.S.⁸⁸ Standard was the largest seller of petrol in the western area (made up of five states) of the U.S. It sold 23 per cent of total petrol in the area - of which 6.7 per cent was sold under exclusive dealing. It controlled 16 per cent of the retail market. Its six leading competitors sold 42.5 per cent of total petrol through service stations. These competitors also used exclusive dealing. Over 70 other companies supplied the balance of the petrol. The U.S. Government challenged Standard's exclusive dealing contracts under s. 3 of the Clayton Act. The issue was whether showing that a "substantial portion" of the relevant market was affected breached s. 3, i.e. did this mean that the exclusive dealing contract's effect "may be to substantially lessen competition".⁸⁹ In

85 Pick Manufacturing Co. v General Motors 299 U.S. 3 (1936); FTC v Sinclair Refining Co. 261 U.S. 463 (1923); Pearsall Butter v FTC 292 F. 2d 720 (7th Cir. 1923).

86 Ibid.

87 ROSS, *supra*, note 35, at 312.

88 377 U.S. 292 (1949).

89 Id. at 299.

essence, the issue was whether the standard then applying to tying arrangements applied to exclusive dealing. Justice Frankfurter, in the majority opinion, noted that tying agreements "... serve hardly any purpose beyond the suppression of competition".⁹⁰ He then stated that exclusive dealing could be economically advantageous to both buyers and sellers and thus, to consumers. He noted that this seems to require courts to evaluate exclusive dealing's competitive effects on a case by case basis. He then held that such an evaluation was beyond court's competence. He held that s. 3 was satisfied "by proof that competition has been substantially foreclosed in a substantial share of level of commerce".⁹¹ He concluded that Standard met this test. Commentators called this a quantitative substantiality test.⁹² It meant that exclusive dealing breached s. 3 if a significant dollar value of sales had been foreclosed to competitors. Justice Jackson dissented, claiming the majority's test established a per se rule.⁹³ He agreed that an exclusive dealing clause which foreclosed 6.7 per cent of the market amounted a substantial share of the market. However, he believed this alone did not breach s. 3. He believed courts can and should weigh the benefits to competition from exclusive dealing contracts against their detriments. He pointed at the advantages of exclusive dealing in this case. These were the advantages that Justice Frankfurter had identified.⁹⁴ Justice Douglas also

90 Id. at 305.

91 Id. at 314.

92 ROSS, *supra*, note 35, at 312; Steuer, *supra*, note 2, at 118.

93 377 U.S. 293, 323.

94 Id. at 306; see text accompanying notes 16-17 *supra*.

dissented on Jeffersonian grounds that invalidating the contracts would lead to more harmful alternatives, viz; the large firms entering the retail market by vertical integration and eliminating the small firms.⁹⁵

Commentators have severely criticised Justice Frankfurter's opinion.⁹⁶ Not only was it contrary to precedent and s. 3's legislative history,⁹⁷ but it also ignored economics. Professors Thomas Krattenmaker and Steven Salop argue Justice Frankfurter disclaimed the relevance of the only possible antitrust problem (the impact on competition), ignored a procompetitive explanation for the contracts (they were efficiency enhancing) and focused on a competitively neutral fact (the substantial amount of commerce involved).⁹⁸

As Justice Jackson noted, the majority opinion virtually imposed a per se ban on exclusive dealing.⁹⁹ A plaintiff only had to prove the exclusive dealing contract foreclosed a significant dollar volume to rival stock. Whether exclusive dealing affected rivals ability to compete was irrelevant.

However, this changed in Tampa Electric Co. v Nashville Coal Co.¹⁰⁰ Tampa was a public electric utility. Nashville was a coal company. Tampa contracted with Nashville, for Nashville to supply all of its coal requirements for

95 Id. at 320-321; Justice Douglas proved to be correct; See SULLIVAN and HARRISON, *supra* note 15, at 181.

96 BORK, *supra*, note 33, at 299-301; ROSS, *supra*, note 35, at 312-313.

97 ROSS, *supra*, note 35, at 313.

98 Krattenmaker and Salop, Anticompetitive Exclusion : Raising Rivals' Costs to Achieve Power over Price, 96 YALE L.J. 209, 219-220 (1986).

99 377 U.S. 293, 323 (1949).

100 365 U.S. 320 (1961).

20 years. Tampa could only buy from Nashville while, Nashville could only sell to others after it had fulfilled Tampa's requirements. Nashville stopped supplying, claiming the requirements contract breached the antitrust laws. Although the contract foreclosed \$128 million of coal sales, the Supreme Court held that it did breach s. 3 of the Clayton Act. The contract only foreclosed 0.77 per cent of the relevant market. However, the Court did not base its decision on market share. It established a three-part test for assessing exclusive dealing under s. 3 of the Clayton Act:

1. The Court must identify the relevant product market to determine the line of commerce affected.
2. The relevant geographic market must be identified.
3. The competition foreclosed by the exclusive dealing must constitute a substantial share of the relevant market, i.e., "the opportunities for other traders to enter into or remain in the market must be significantly limited".¹⁰¹

This was not a statistical test of market share. The Court held to determine the standard of foreclosure one had to analyse, "the relative strength of the parties, the proportionate volume of commerce involved in relation to the total volume of commerce involved in the relevant market area and the probable intermediate and future effects of the agreement on effective competition in the market".¹⁰²

By doing so, the Court rejected the Standard Oil test and substituted what

101 Id. at 327-328.

102 Id. at 329.

commentators called the qualitative substantiality test.¹⁰³ In essence, the Court introduced a broad rule of reason enquiry. While it gave a list of relevant factors to assess exclusive dealing contracts it provided no guide on how to rank them or link them with anticompetitive effect.¹⁰⁴

In F.T.C. v Brown Shoe Co.¹⁰⁵, the Supreme Court held the Tampa standard did not apply to s. 5 of the Federal Trade Commission Act. The F.T.C. ruled that Brown Shoe (then the U.S.'s second largest shoe manufacturer) had entered into exclusive dealing arrangements with 650 retail shoe shops in the U.S. This, the F.T.C. claimed, breached s. 5. The Supreme Court affirmed, stating the F.T.C. had broad powers to prevent practices "which conflict with the basic policies of the Sherman and Clayton Acts even though such practices may not actually violate these laws".¹⁰⁶

The next, and perhaps most important case is not an exclusive dealing case, viz; Continental T.V., Inc. v G.T.E. Sylvania.¹⁰⁷ This involved territorial restrictions and location clauses. The facts are unimportant here. The Court rejected the Schwinn¹⁰⁸ doctrine, that nonprice vertical restraints are per se illegal. The Court held that nonprice vertical restraints could promote

103 ROSS, *supra*, note 35 at 312; Steuer *supra*, note 2, at 118.

104 Mahinka, Vertical Restraints as Exclusionary Practices: Current Issues in Regulated and Deregulated Industries, 3 58 ANTITRUST L.J. 921, 923 (1989).

105 384 U.S. 316 (1966).

106 *Id.* at 321.

107 433 U.S. 36 (1977).

108 U.S. v Arnold Schwinn and Co. 388 U.S. 365 (1967).

competition by enhancing efficiency. Vertical restraints deserved careful analysis on a case by case basis. Vertical restraints could also restrain competition. Thus, the Court had to balance the harms and benefits of each vertical restraint. It explicitly focused on what the economic purpose and effect of the challenged vertical restraints were or were likely to be. It did so more rigorously than previously. Thus, the Court applied a broad rule of reason standard. The importance of Sylvania to exclusive dealing, is that lower courts now employ the Sylvania rule of reason to exclusive dealing. Some do not even quote Tampa.¹⁰⁹

Beltone Electronics Corp.¹¹⁰ shows how important Sylvania has been. Beltone was a manufacturer of hearing aids. It had exclusive dealing arrangements with 7-8 per cent of the U.S.'s hearing aid dealers. The dealers accounted for 16 per cent of sales. The unanimous Federal Trade Commission did not rely on the number of outlets foreclosed in deciding - instead it undertook a full rule of reason enquiry. The Federal Trade Commission stated "a proper analysis of exclusive dealing arrangement should take into account, market definition, the amount of foreclosure in the relevant market, the duration of the contracts, the extent to which entry is deterred and the reasonable justification of any for the exclusivity".¹¹¹

It held exclusive dealing only breaches s. 5 of the Federal Trade

109 See text accompanying notes 176-193 supra.

110 {1979-1983 Transfer Binder} TRADE REG. REP. (CCH) para 21,934 (FTC 1982).

111 Id. at 22, 387.

Commission Act, if on balance there is a "probably adverse effect on interbrand competition".¹¹² The Federal Trade Commission found no breach.

A minority of the Supreme Court revisited exclusive dealing in Jefferson Parish Hospital District No. 2 v Hyde.¹¹³ This concerned a five-year exclusive contract between a hospital and a group of anaesthesiologists. The majority viewed and decided the case as involving tying. The concurring minority also treated it as exclusive dealing. Justice O'Connor stated:

"In determining whether an exclusive dealing is unreasonable, the proper focus is on the structure of the market for the products or services in question - the number of sellers and buyers in the market, the volume of their business and the ease with which buyers and sellers can redirect their purchases or sales to others. Exclusive dealing is an unreasonable restraint on trade only where a significant fraction of buyers or sellers are frozen out of a market by the exclusive dealing".¹¹⁴

The opinion concluded the exclusive dealing contracts, which foreclosed 30 per cent of the market, were reasonable as they did not foreclose anyone out of the market.

Judge Richard Posner provided the next significant analysis of exclusive dealing in Roland Machinery Company v Dresser Industries, Inc.¹¹⁵ Dresser manufactured farm machinery. Roland was a large construction equipment dealer in Illinois. Dresser and Roland entered into an exclusive dealing agreement. Either party could terminate the agreement on 90 days notice.

112 Id. at 22,393.

113 466 U.S. 2 (1984).

114 Id. at 45.

115 749 F. 2d 380 (7th Cir. 1984).

Roland then agreed to sell products made by Komatsu, one of Dresser's rivals. Komatsu was the second largest manufacturer of construction equipment in the world. Dresser sought to end its agreement with Roland. Roland sought and obtained an injunction at first instance. The Seventh Circuit Court of Appeals reversed. While Judge Posner's comments on exclusive dealing were obiter, he announced a two-part test for exclusive dealing to breach s. 3 of the Clayton Act. The plaintiffs must show:

1. Exclusive dealing actually foreclosed at least one significant competitor from the relevant market.
2. The probably (not certain) effect of the exclusion will be to raise prices above (and therefore decrease output below) the competitive level ... :
 "He must show in other words that the anticompetitive effects (if any) of the exclusion outweigh any benefits to competition from this".¹¹⁶

Judge Posner held the exclusive dealing here, did not breach s. 3. It was of short duration. Competitors in the relevant market could easily establish their own distributors. He emphasised the procompetitive effects of exclusive dealing. It leads distributors to promote each manufacturer's brand more vigorously, it lowers quality adjusted price and it prevents distributors and rival manufacturers from free riding on manufacturer's effort on brand promotion.¹¹⁷

Thus, U.S. courts undertake a rule of reason analysis in evaluating exclusive dealing. Once they have identified the relevant market, they examine a number of factors in determining the legality of the exclusive dealing. One

116 Id. at 394.

117 Id. at 394-395.

must emphasise U.S. courts undertake a full enquiry. No one of the following factors by itself will be determinative.

1. The Percentage of Market Foreclosed:

Historically, courts have found exclusive dealing reasonable with market shares of less than 20 per cent.¹¹⁸ As the percentage foreclosure share rises beyond 20-30 per cent the probability of courts finding violations increases.¹¹⁹ However, courts are increasingly blessing market foreclosure of over 40 per cent.¹²⁰ Indeed, one court found no violation when the defendant had an 80 per cent market share.¹²¹

118 See e.g., Satellite Television and Associated Resources, Inc. v Continental Cablevision, 714 F. 2d 351, 357 (4th Cir. 1983), (foreclosure of 8 per cent of households), cert denied 465 U.S. 1027 (1984); American Motor Inns v Holiday Inns, 521 F. 2d 1230, 1252 (3d Cir. 1975), (14.7 per cent); Cornwell Quality Tools Co. v C.T.S. Co., 446 F. 2d 825, 831 (9th Cir. 1971), (10-15 per cent), cert denied 404 U.S. 1049 (1972).

119 See e.g., Twin City Sportservice v Finley, 676 F. 2d 1291 (9th Cir. 1982) (long term foreclosure of 24 per cent of market illegal); However, since Hyde (see supra, note 113) courts are more willing to bless foreclosure of over 30 per cent, see e.g., Kuck v Bensen, 647 F. Supp. 743 (B.D. Mo. 1986), (foreclosure of 37 per cent legal).

120 See e.g., Sewell Plastics v Coca-Cola, 720 F. Supp. 1186 (W.D.N.C. 1988), (40 per cent market share lawful), aff'd mem. 912 F. 2d 463 (4th Cir. 1990); Gonzalez v Insignares, {1985-1986 Trade Cases}, (CCH), para 66,701 (N.D. Ga. 1985), (foreclosure of 40 per cent lawful); Hendricks Music v Steinway, 689 F. Supp. 1501 (N.D.I. 1988), (48 per cent Market share upheld); cf. Kohler Co. v Briggs and Stratton Corp. 1986 - I Trade Cases (CCH) para 67,047 (E.D. Wis. 1986) (62 per cent market share, preliminary injunctions issued); Oltz v St Peter's Community Hospital, 656 F. Supp. 760 (D. Mont. 1987) (84 per cent market share illegal), aff'd 861 F. 2d 1440 (9th Cir. 1988).

121 Barry Wright Corp. v ITT Grinnell Corp., 724 F. 2d 227 (1st Cir. 1983); City of Chanute, Kansas v Williams Natural Gas Co., 955 F. 2d 641 (10th Cir. 1992) arguable may have involved a greater market share as may

2. Duration of Agreement:

The shorter the agreement, the more likely a court will find it reasonable.¹²² The length of an agreement is important as some courts will not invalidate the contract as a whole, but will rather decrease its length.¹²³ Judge Posner has held that, "exclusive dealing clauses terminable in less than one year are presumptively lawful".¹²⁴ However, it is only a presumption.

3. Ability to End an Agreement:

Closely related to the agreement's duration, is the ability to end it easily. If the parties can end it without reason, on short notice, courts will likely hold that it is reasonable.¹²⁵

have Fleer Corp. v Topps Chewing Gum, Inc. 658 F. 2d 139 (3rd Cir. 1981).

122 Twin City Sportservice v Finley, 676 F. 2d 1291 (9th Cir. 1982), (10 years plus duration found unlawful), cert denied, 459 U.S. 1009 (1982); Ferguson v Greater Pocatello Chamber of Commerce, 848 F. 2d 976, 982 (9th Cir. 1988), (six year lease upheld); Barry Wright Corp. v ITT Grinnell Corp., 724 F. 2d 277 (1st Cir. 1983), (Two year limit upheld); U.S. v Pfizer, 246 F. Supp. 464, 470-471 (E.D.N.Y. 1165), (one year upheld); Satellite Fin. Planning Corp. v First National Bank, 633 F. Supp. 386, 397 (D. Del. 1986) (exclusive dealing contract terminable on 180 days notice upheld).

123 F.T.C. v Motion Pictures Advertising Co. 344 U.S. 392 (1953), (Supreme Court cut exclusive dealing contract's duration from five years to one).

124 Roland Machinery Co. v Dresser Industries, Inc., 749 F. 2d 380, 395 (7th Cir. 1984). Roland Machinery Co. v Dresser Industries, Inc., 749 F. 2d 380 (7th Cir. 1984).

125 Denison Mattress Factory v Spring-Air Co. 308 F. 2d 403, 412 (5th Cir. 1962), (upheld contract terminable without cause on six months notice); Belton Electronics Corp. 100 F.T.C. 68 at 210 (1982), (dealer could terminate on thirty days notice).

4. Nature of Purchaser:

A distributor needs to show a greater level of foreclosure resulting from exclusive dealing than a consumer does.¹²⁶

5. Ease of Entry:

The easier it is for firms to enter the market, the more likely courts are to uphold exclusive dealing. High entry barriers make it more likely than a court will invalidate.¹²⁷

6. Presence of Alternative Distribution Channels:

If alternative distribution channels exist and enable a supplier's competitors to reach the market, the courts are more likely to find the exclusive dealing reasonable.¹²⁸

7. Type of Product:

Courts will most likely uphold exclusive dealing if it involves a shopping

126 Ryko Manufacturing Co. v Eden Services, 823 F. 2d 1215, 1235-1236 (8th Cir. 1987).

127 See Brown Shoe, 104 F.T.C. 266 (1984); E & J Gallo Winery, 101 F.T.C. 727 (1983); Beltone Electronics Corp. 100 F.T.C. 68, 204 (1982).

128 Haagen-Dazs Co., Inc. v Double Rainbow Gourmet Ice Cream, Inc., 895 F. 2d 1417 (9th Cir. 1990); Refrigeration Engineering Corp. v Frick Co., 370 F. Supp. 702 (W.D. Tex. 1974); Bowen v New York News, Inc., 366 F. Supp. 651 (S.D.N.Y. 1973); Seagood Trading Corp. v Jenico Inc., 924 F. 2d 1555, 1572-1573 (11th Cir. 1991); Stitt Spark Plug Co. 840 F. 2d 1253, 1258 (5th Cir. 1988).

product.¹²⁹

8. Use of Exclusive Dealing by Competitors:

Courts may view exclusive dealing less favourably if a supplier's competitors use it. However, widespread use is not determinative.¹³⁰

9. Actual Competitive Impact:

Generally, courts require proof that exclusive dealing has harmed competition before finding exclusive dealing unlawful.¹³¹ Courts have examined the link between the exclusive dealing contract and the alleged antitrust harm.¹³²

129 U.S. v J.J. Case Co. 101 F. Supp. 856 (D. Minn. 1951).

130 See Tampa, 365 U.S. 320, 344 (1961); Standard Oil 377 U.S. 293, 309 and 314 (1949); but see also Joyce Beverages Inc. v Royal Crown Cola Co. 555 F. Supp. 271, 275 (S.D.N.Y., 1983) (exclusive dealing may enhance interbrand competition when all competing suppliers use it); United Airlines, Inc. v Austin Travel Corp. 681 F. Supp. 176 (S.D.N.Y., 1988); Aff'd 867 F. 2d 737 (2nd Cir. 1989), (exclusive dealing lawful where other major competitors have similar five year contracts).

131 Joyce Beverages, 555 F. Supp. 271 (S.D.N.Y., 1983) (exclusive dealing lawful in market with fierce interbrand competition); Ralph C. Wilson Industries, Inc. v Chronicle Broadcasting Co., 794 F. 2d 1359 (9th Cir. 1986); Westman Commission Co. v Hobart International, Inc., 796 F. 2d 1216 (10th Cir. 1986); Taggart v Rutledge, 852 F. 2d 1290 (9th Cir. 1988), (no evidence that competition harmed).

132 Interface Group v Massachusetts Port Authority, 816 F. 2d 9 (1st Cir. 1987), (no connection between agreement and antitrust harm); Community Hospital v Tomberlin 712 F. Supp. 170 (M.D. Ala. 1989).

10. Procompetitive Effects and Justifications:

Courts will consider the justifications and procompetitive effects a defendant claims flow from an exclusive dealing contract.¹³³ The Courts expressly consider any prevention of free riding claims.¹³⁴

11. Seller's Market Power:

Courts increasingly will not invalidate exclusive dealing, unless a seller possesses market power. They do so, because a seller without market power cannot cause any anticompetitive harm.¹³⁵

Canadian Law:

Section 31.4(2) of the Combines Investigation Act used to govern exclusive dealing in Canada. In 1985 the Canadian Legislature enacted the Competition Act. Section 77 of that Act now governs exclusive dealing. However, the two provisions are virtually identical. The first Canadian exclusive dealing decision was Director of Investigation v Bombardier.¹³⁶ This involved the Combines Investigation Act. Bombardier produced snowmobiles. It was the

133 Tampa, 365 U.S. 320 (1961); Ryko Manufacturing Co. v Eden Services, 823 F. 2d 1215 (8th Cir. 1987); Roland, 749 F. 2d 380 (7th Cir. 1984).

134 Roland, 749 F. 2d 380, 384-385 (7th Cir. 1984); Sewell Plastics, 720 F. Supp. 1196 (W.D.N.C. 1989); Haagen Dazs Co., 895 F. 2d 1417 (9th Cir. 1990) (exclusive dealing, inter alia, prevents free riding).

135 Assam Drug Co. v Miller Brewing Co., 798 F. 2d 311 (8th Cir. 1986); Graphic Products Distributors, Inc. v Itek Corp., 717 F. 2d 1560 (11th Cir. 1983).

136 (1981) 53 CPR (2d) 7 (RTPC).

only Canadian manufacturer. However, there were no tariffs on imports. The other manufacturers were Japanese and American companies. Bombardier had 30 per cent of all the North American sales, 60 per cent in Quebec and 40 per cent in Ontario. It entered into exclusive dealing contracts with its distributors. The distributors agreed not to carry Bombardier's rivals' products. The contracts lasted for a year. The Restrictive Trade Practices Commission upheld the exclusive dealing. The Commission held Bombardier was a major supplier. It stated that the essential question in determining whether Bombardier's exclusive dealing substantially lessened competition was whether Bombardier's rivals were able to find a sufficient number of dealers to market their product.¹³⁷ It held Bombardier's rivals could. It held entry into the retail market and therefore the exclusive dealing did not impede rivals. It held so because only relatively low numbers of sales were necessary to maintain a snowmobile distributorship. Distributors could supplement this business by carrying complementary goods and services. There was also a considerable turnover of distributors. Most communities had more than one distributor. However, some communities only had a Bombardier distributor. The Commission admitted that the easiest way for Bombardier's rivals to enter these communities was to have Bombardier distributors carry their product or "dual".¹³⁸ It conceded that until Bombardier's rivals obtained their own distributors consumer choice was reduced. However, it held that once the rivals obtained their own distributors that consumer choice was greatly increased. Consumers then had a choice of

137 Id. at 25.

138 Ibid.

product and distributors. Thus, exclusive dealing ultimately leads to an increased number of dealers in an area and thus, actually increases competition.¹³⁹

Doctor Geoffrey Takach says this shows that the Commission recognises that some exclusive dealing situations, rather than merely not lessening competition, actually have the positive effect of encouraging it.¹⁴⁰ The Commission also held that it was easy for Bombardier's rivals to obtain their own distributors.¹⁴¹

The next, and thus far only, case is Director of Investigation and Research v Nutra Sweet Co.¹⁴² Nutra Sweet manufactured aspartame, a sweetener used in soft drinks. Canada authorised aspartame use in 1981. In 1987, Nutra Sweet's patent expired. Nutra Sweet was responsible for all U.S. and Australian sales (where a patent still applied). It had 80 per cent of the market in Europe and 95 per cent in Canada. It had 65 customers in Canada - although five per cent of the customers purchased approximately 84 per cent. The only other supplier was Tosoh, who had five per cent of the market. Tosoh started production in 1987, when the Nutra Sweet's patent expired. Nutra Sweet then entered into one year requirements contracts with its customers. Nutra Sweet bought some

139 Id. at 27.

140 Takach, Exclusive Dealing after Bombardier: The Law is not a great deal clearer than before, 8 CAN. BUS. L. REV. 226, 230 (1983-84).

141 Gideon Rosenbluth criticises the decision. See Rosenbluth, Competition Policy Bombs Again: The Bombardier Case, (unpublished paper, University of British Columbia 1981).

142 (1990) 32 CPR (3d) 1; See Collins, The Law and Economics of "Abuse of Dominant Position" : An Analysis of Nutra Sweet, U. Toronto Fac. L. Rev. 275 (1991); Thompson, Nutra Sweet : The Evolution of Law on Abuse of Dominant Position 18 CAN. BUS. L. REV. 17 (1991).

of its aspartame from a Japanese company called Ajinomoto. Ajinomoto had agreed not to enter the North American market until 1996. Nutra Sweet requirements contracts were subject to (inter alia) the following conditions: A "meet or release" clause. This required Nutra Sweet to release a customer from its contract if the customer received a more favourable offer which Nutra Sweet refused to meet. A "most favoured nation" clause. This guaranteed a customer "the lowest price paid by any customer for an equivalent volume".¹⁴³ When this happened, the customer received a rebate cheque for the difference at the year's end. Nutra Sweet also supplied customers a discount (of up to 40 per cent), if customers used the Nutra Sweet name on packaging and advertising. This meant customers had to pay substantially more if they did not qualify for the discount. In essence, Nutra Sweet offered a monetary incentive to use its aspartame. The Competition Tribunal held Nutra Sweet had breached both the Section 77, Exclusive Dealing and Section 79, Abuse of a Dominant Position provisions of the Competition Act. Discussing Section 77 the Tribunal noted:

"The exclusivity in [Nutra Sweet's] contracts, which includes both the clauses reflecting the agreement to deal only or primarily in Nutra Sweet brand aspartame and the financial inducements to do so, impedes "toe-hold entry" into the market and inhibits the expansion of other firms in the market. Since exclusive use and supply clauses appear in virtually all of [Nutra Sweet's] 1989 contracts and thus cover over 90 per cent of the Canadian for aspartame, it is clear that during the currency of those contracts there is little room for entry by a new supplier".¹⁴⁴

The Tribunal held that the meet or release clauses dissuaded entry and that they discouraged rivals from submitting bids. It emphasised the fidelity

143 Nutra Sweet (1990) 32 CPR (3d) 1, 66.

144 *Id.* 48-49.

rebates associated with the use of the Nutra Sweet logo.¹⁴⁵ It also considered the evidence of customers that they were reluctant to switch from Tosoh and go from Nutra Sweet and go to Tosoh. However, the Tribunal did not reconcile this with the fact that two of Nutra Sweet's customers, Cadbury Schweppes and Stafford Foods had switched to Tosoh.

Again, the case seems to show a benign attitude to exclusive dealing. Nutra Sweet's market share was huge. It had the advantage of enormous economies of scale and distribution of up to one third of the world's production. The discount and use of the Nutra Sweet logo were extremely relevant in finding a breach of Section 77. Indeed, the Tribunal indicated that the contract's term might not be anticompetitive, were it not for the effect of the long term use of the logo on entry conditions in the future.¹⁴⁶

Australia:

Section 47 of the Trade Practices Act governs exclusive dealing. Section 47(2)(d) prohibits the practice, where it has the purpose or is likely to have the effect of substantially lessening competition. Ford Motor Co. of Australia Ltd¹⁴⁷ still represents the law in Australia. Ford held about 22 per cent of the Australian market for new vehicle sales. It controlled sites accounting for 45 per cent of its total sales. It had exclusive dealing contracts with 14 per cent of its dealers. It applied to the Trade Practices Commission for authorisation of its

145 Ibid.

146 Id. at 49-51.

147 (1977) 32 FLR 65.

agreement.¹⁴⁸ The Trade Practices Commission denied authorisation. Ford applied for review to the Trade Practices Tribunal. The Tribunal also denied authorisation. It held that foreclosure of 14 per cent of dealers impeded entry for Ford's current and potential rivals. It noted that 86 per cent of other dealers were not available to rivals, because many of them might be unwilling to acquire another franchise. It also found the exclusive dealing lessened the degree of competition between dealers. The Tribunal found that by eliminating the agreements, Ford would lose 1-5 per cent of the market share. The Tribunal concluded the agreement thus, resulted in the substantial lessening of competition. It rejected Ford's procompetitive benefits of the agreements, viz; greater efficiency, the prevention of rural monopolies, the demonstration of relative efficiencies between different distribution systems, dealer assistance, increase in Australian employment, product improvement and improved product service. The Tribunal held Ford did not prove these or show they flowed from the exclusive dealing arrangement. While accepting the exclusive dealing arrangement maximised Ford's sales, the Tribunal held this did not mean it benefitted competition.¹⁴⁹ Benefitting the strongest supplier was irrelevant in assessing the effect on competition. The Tribunal found Ford's exclusive dealing contracts had anticompetitive effects, viz; constriction of dealer freedom and an elimination of side by side selling.¹⁵⁰

148 ATP Commission Decisions June 1976-January 1977, 16, 563.

149 Ford, (1977) 32 FLR 65 and 85.

150 *Id.* at 86.

Commentators have severely criticised this decision.¹⁵¹ Because, Ford controlled sites accounting for 45 per cent of its sales, the exclusive dealing agreements only foreclosed 12 per cent of total market sales volume. How is this significant? It is certainly far below the foreclosure percentage counts have found detrimental in the U.S. and Canada. Why is a possible loss of 1-5 per cent a substantial lessening of competition? If it is, very little exclusive dealing will escape condemnation. The decision is delphic in its reasoning. As Shannon noted what did the tribunal mean by saying:

"In reaching our conclusion that the lessening of competition resulted from the restriction is substantial, we have placed considerable weight on the significance of Ford in the motor vehicle industry. We would have arrived at the same conclusion without the experts giving any evidence of the loss of market share by Ford in the event of the restrictive provision being removed".¹⁵²

As Shannon notes, in fact, the Tribunal failed to indicate any alternative basis on which it could have concluded the degree of lessening of competition was substantial.¹⁵³ One must also wonder why the Tribunal found that 86 per cent of the non-Ford dealers were potentially unavailable to Ford's rivals. If Ford's rivals offered a superior product, which would mean more sales for dealers, the dealers should have been willing to shift. The Tribunal did not consider in any great detail how easy it was for Ford's rivals to establish new dealers. Presumably the number of dealers was not finite.

151 D. SHANNON, *FRANCHISING IN AUSTRALIA A LEGAL GUIDE* 172-174 (1982).

152 *Id.* at 174.

153 *Ibid.*

However, as both Shannon and Doctor James Farmer,¹⁵⁴ have noted, perhaps the only explanation for the decision is bad lawyering. Ford called no economic evidence and its lawyers thought up all economic arguments.

Australian courts have also held exclusive dealing can breach s. 46 of the Trade Practices Act. To constitute a breach, a firm with substantial market power must enter into such contracts with its distributors. The contracts must have a foreclosing effect by denying rivals access to those distributors. In re Tubemakers¹⁵⁵ is illustrative. Here, Palmer Tube Mills (Palmer) requested the Trade Practices Commission to revoke a notification of some of Tubemakers exclusive dealing contracts. Tubemakers had terminated its independent Queensland distributor, Steelmark (Qld) Ltd, for purchasing tube from Palmer. The Commission found the market to be "small-diameter, thin-walled steel pipe and tubing in Australia".¹⁵⁶ Tubemakers had 67.8 per cent of the market, Palmer two per cent, another Australian company (Hills) had 25.6 per cent, while imports accounted for the rest. Given these market shares, the Commission revoked Tubemaker's exclusive dealing contracts notification. The Commission held the exclusive dealing contracts raised Palmer's costs of entry into the market.¹⁵⁷ Tubemakers, subsequently stopped its exclusive dealing, rather than face a trial.

154 Farmer, Economic Evidence - Some Practical Issues, in New Zealand Law Society Supplementary Papers : Economics and the Law the Application of Economics in Legal Practice, 6 (1990).

155 ATP Commission Decision April 1988, 1.

156 Id. at 8.

157 Id. at 34.

Trade Practices Commission v CSR Ltd¹⁵⁸ involved (inter alia) exclusive dealing. CSR had 80 per cent of the market for plasterboard in Western Australia. It stopped supplying one of its distributors, North Perth Plaster Works Pty Ltd. North Perth has started taking deliveries from one of CSR's rivals. After North Perth complained to the Trade Practices Commission, CSR admitted liability. French J. imposed a fine of \$220,000.

APPLICATION OF THE RRC MODEL TO FISHER AND PAYKEL:

The best way of assessing whether the RRC model is of any use, is to apply it to a decided case and see whether it offers any benefits over traditional analysis. An apposite New Zealand case is Fisher & Paykel v Commerce Commission.¹⁵⁹ I propose to analyse this case using the RRC model. It is a paradigm RRC case, as it involved an exclusive dealing contract. This is exactly the type of case Krattenmaker and Salop argue courts should analyse using the RRC model.

Facts:

Fisher and Paykel (F&P) is the leading manufacturer and distributor of whiteware in New Zealand. By 1990 it was New Zealand's only whiteware manufacturer. The winds of the free market blew through New Zealand in the 1980's and from 1987 the government exempted all Australian whiteware from import licensing and abolished tariffs. The government abolished import licenses

158 (1991) ATPR para 41-076.

159 [1990] 2 NZLR 731.

from whiteware from other countries and reduced tariffs to 10 per cent by 1996. This led to increased competition in the whiteware market. F&P was still the major player with approximately 80 per cent of the market. F&P had an exclusive dealing contract (EDC) over its dealers, which it had used for 40 years. The EDC required dealers not to stock or sell other manufacturers' whiteware. The EDC was terminable by either party on 90 days notice. F&P had 204 franchised dealers who sold to 450 outlets. There were approximately 800-850 New Zealand outlets which sold whiteware. In 1987 F&P applied to the Commerce Commission for an authorisation, which involved determining, *inter alia*, whether the EDC breached Section 27. In 1989, the Commission by a majority, held the EDC did. F&P appealed. Various parties joined the action. The High Court held the EDC did not breach Section 27.

Issue:

The issue in the case was "does the EDC between F&P and its retail dealer outlets have the effect of substantially lessening competition in a market for the distribution and sale to retailers of white goods?"¹⁶⁰ All parties agreed the market was New Zealand-wide. All the parties, the experts, the Commission and the High Court accepted that the EDC could breach s. 27 if it raised F&P's rivals' costs. They disagreed whether it did. While the experts posed an RRC question, none expressly adopted Krattenmaker and Salop's model.

¹⁶⁰ *Id.* at 743.

Q: What RRC scenario was involved?

1. Bottleneck:

This requires the retailers not to be equally efficient, or some of the retailers to be more important or advantageous to manufacturers. Examples, would be the only shop in town or a well regarded chain of shops throughout the country. If F&P purchased an exclusionary right (or entered into an EDC) from such retailers, this would leave rivals facing higher input prices and thus, higher costs. This requires the demand of R&P's rivals to be large relative to the number of unrestrained sellers. It requires the unrestrained retailers to be unable to afford to expand their capabilities. It also requires high entry barriers to the retail market to prevent new retailers entering and meeting the rival's increased demand for quality retail space.

2. Real Foreclosure:

This requires F&P to have acquired an ER (or entered into an EDC) from such a large percentage of retailers that the market price for the supply of the remaining space is driven up, so increasing rivals' costs. Again, this requires the demand of F&P's rivals to be large, relative to the number of unrestrained retailers. It requires the unrestrained retailers being unable to meet the rivals' demand. It requires high costs of expansion and high entry barriers to potential entrants to the retail market.

3. Cartel Ringmaster:

This requires F&P, after having purchased an ER (entered into an EDC) from a large percentage of retailers, to orchestrate a cartel among the remaining unrestrained retailers to increase prices for F&P's rivals. This leads F&P's rivals facing increased input costs and thus, higher costs. This again requires F&P's rivals' demand for retail space to be large relative to the number of unrestrained retailers. It requires entry to the retail market to be difficult, as cartel pricing would really attract new entrants. It requires the number of rivals to be small, to make it likely that F&P could orchestrate a cartel.¹⁶¹

4. Frankenstein Monster:

This requires F&P to have acquired an ER (entered into an EDC) from a large percentage of retailers, leaving the unrestrained retailers so concentrated, they could form a cartel and charge F&P's rivals cartel prices. Once again the rivals would have higher input costs and thus, higher costs. This again requires high entry barriers to prevent new entrants attracted by the cartel prices. Again the number of unrestrained retailers must be small to make a cartel likely.¹⁶²

To summarise the scenarios require the following conditions to be met before the rival's costs are raised:

Bottleneck and Real Foreclosure will require:

- (a) The existing unrestrained retailers being unable to meet F&P's rivals' increased demand for retail space.

¹⁶¹ STIGLER, *supra*, note 69.

¹⁶² *Ibid.*

- (b) The existing unrestrained retailers facing high costs of expansion to meet the rivals' increased demand.

Cartel Ringmaster and Frankenstein Monster require:

- (a) The number of existing unrestrained retailers to be small to make a cartel likely.

All four require:

- (a) Significant entry barriers for potential entrants into the whiteware retail market.

Q: What scenarios were involved in F&P?

No one could possibly suggest that either the Cartel Ringmaster or Frankenstein Monster scenarios were involved. Counsel for the Commerce Commission and F&P's rivals did not. There were more than 400 unrestrained retailers. It would take a truly heroic effort by F&P to orchestrate such a large cartel. Similarly the unrestrained retailers would have to collude to an unprecedented degree to form a cartel by themselves. Such a cartel would fly apart extremely quickly after forming - if one was ever formed.¹⁶³ The two scenarios that were possibly in play, were Bottleneck and Real Foreclosure.

1. Bottleneck:

It was alleged and a majority of the Commission agreed that there were prime positions for retail outlets and F&P had tied up the greater proportion of these. F&P's rivals' counsel described these as best quality or key retailers and

¹⁶³ Ibid.

also as chain or department stores.¹⁶⁴

2. Real Foreclosure:

Again, by virtue of having EDCs with the key best and quality retailers, F&P had employed the real foreclosure model. Similarly, tying up 400-500 out of 800-850 retail outlets is real foreclosure.

Under RRC identifying a possible RRC scenario is not enough to establish that F&P had raised its rivals' costs. One must examine the input (here, whiteware retail shop) market.

The two scenarios only raise rivals' costs if:

- (a) The existing, unrestrained retailers cannot meet F&P's rivals' increased demand for retail space.
- (b) The unrestrained retailers cannot expand to meet the increased demand (i.e. it is prohibitively expensive for them to do so).
- (c) High entry barriers exist in the retail whiteware market which prevents new retailers entering to meet the increased demand.

In short, demand in the retail whiteware market must be inelastic.

The High Court found these conditions were not met. The High Court did not use the RRC model but discussed these factors. It held the supply of suitable retail space throughout New Zealand was relatively elastic. Existing retailers could expand their capacity relatively inexpensively by converting existing shop floor space to selling whiteware. This meant the existing retailers already had the ability to meet F&P's rivals' increased demand. They could also

164 [1990] 2 NZLR 731 at 741.

expand by building new retail space relatively inexpensively. Entry barriers for new entrants were not high as it was also relatively inexpensive to enter the retail whiteware market. It was also easy for restrained F&P dealers to terminate their exclusive dealing agreements and switch allegiance to F&P's rivals. Thus, under the RRC model, R&P's rivals could not establish the first limb of Krattenmaker and Salop's test. The exclusive dealing contracts did not significantly and substantially raise rivals' costs. This conclusion depends upon it being relatively inexpensive for rivals to expand and for new entrants to enter. (This requires empirical testing.) The majority of the Commerce Commission thought differently.¹⁶⁵ It expressly found the EDC significantly raised F&P's rivals' costs of distribution. Why the difference? One can only agree with Professor Klein's (one of F&P's expert witnesses) view who noted:

"I believe the majority of the Commission failed to appreciate the Fisher and Paykel exclusive dealing arrangement had not the effect of creating commercially insurmountable entry barriers to competing whiteware suppliers by preventing them from obtaining adequate retail distribution of their products".¹⁶⁶

A court applying RRC model would stop here. It would not consider whether F&P had power to price above the competitive level. The case is silent on whether F&P could charge supra competitively. If a court were to analyse the second limb, it would examine the output market and consider the following:

- (a) The extent of competition from F&P's rivals.

165 Id. at 743.

166 Klein, Perfect Competition as a Criterion for Antitrust Policy : Brand Names, Entry Barriers and Exclusive Dealing in the Fisher & Paykel Case, in COMPETITION LAW AND POLICY IN NEW ZEALAND 65, 71 (R. Ahdar ed. 1991).

- (b) The effect of potential rivals, i.e. whether supracompetitive pricing would attract new entrants.

In assessing this, a court would consider whether there are high entry barriers to the output market. It appears there were not, given that there was no import licensing and that Australian imports faced no tariff barriers and nonAustralian imports were only facing temporary tariffs. Indeed, F&P's rivals success at entering the market shows the barriers were not insurmountably high. Thus, R&P's rivals would not meet the second limb of the RRC test.

It is ironic that Professor Klein who employed an RRC-like analysis did not consider the second limb. He thought the exclusive dealing contract did not raise R&P's rivals' costs - but he did not require a showing of market power. However he said: "Exclusive dealing arrangements have anticompetitive effects only if they lead to the exclusion of rivals by prohibitively raising rivals' costs of the critical input".¹⁶⁷ Presumably, if rivals' costs were raised prohibitively, market power would flow from that.

An alternative perspective of the case:

One must remember that one cannot impose U.S. antitrust theories holus bolus into the Commerce Act. As the High Court noted in Union Shipping (N.Z.) Ltd v Port Nelson Ltd: "... it is the task of New Zealand Courts to interpret the Commerce Act. It is not a matter of importing common law doctrine".¹⁶⁸

The Court of Appeal in Telecom Corp. N.Z. Ltd v Commerce

¹⁶⁷ Id. at 70.

¹⁶⁸ [1990] 2 NZLR 662 at 705.

Commission commented: "It is a dangerous method of statutory interpretation to substitute words which a legislature has not in fact chosen".¹⁶⁹

Fisher & Paykel appears to have been argued in the context that Professors Baxter and Klein laid down, viz; The exclusive dealing contract would only breach s. 27 if it "prohibitively raised rivals' costs".¹⁷⁰ Section 27 not only prohibits conduct which prevents competition but also conduct which hinders it. Preventing "suggests stopping potential competition from occurring",¹⁷¹ whereas hindering suggests that it is "making it more difficult to occur".¹⁷² The inclusion of hindering in the phrase lessening of competition widens s. 27's ambit. There are some types of anticompetitive conduct where a plaintiff may have little difficulty in establishing a hindering of competition, but where he or she may have some difficulty in establishing an actual lessening of competition in any quantitative sense. TV3 v TVNZ¹⁷³ emphasises that a plaintiff must expressly identify and plead a hindering of competition if he or she intends to rely on the hindering limb. It appears F&P's rivals' counsel did not expressly identify and plead a hindering.

Although, F&P's exclusive dealing contract did not prohibitively raise F&P's rivals' costs by creating "insurmountable entry barriers",¹⁷⁴ it did make

169 [1992] 3 NZLR 429 at 434.

170 Klein, *supra*, note 166, at 70.

171 Tennants (Lanchashire) Ltd v C.S. Wilson & Co. Ltd [1917] AC 495, 518.

172 *Ibid.*

173 TV3 Network Ltd (in rec.) v Television New Zealand Ltd, Auckland CP No 929/91, Temm J. Judgement 18 December 1992 at 16-17.

174 Klein, *supra*, note 166, at 70.

it more difficult for new entrants to enter the market and for the rivals to expand their capacity. It made it more difficult for F&P's rivals to compete. Arguably this could well amount to a hindering and thus, a breach of s. 27.

The above interpretation of s. 27 does not affect the validity of using the RRC model to assess how F&P's exclusive dealing clause could have raised rivals' costs. However, it means Krattenmaker and Salop's second test of market power is unnecessary under s. 27. Section 27, especially when a plaintiff alleges a hindering of competition, requires less than a market power test. Thus, under s. 27 a court would impose liability on the defendant who simply raised rivals' costs. The ability to price supracompetitively is unnecessary.

Efficiency Defence:

Finally, if the High Court had held the exclusive dealing contract raised rivals' costs and allowed F&P to price supracompetitively, Krattenmaker and Salop's model would possibly allow an efficiency test. A court would consider whether the exclusive dealing clause prevented free riding and switch selling. If so, a court would consider whether preventing these justified the exclusive dealing contracts. The High Court considered efficiency justifications in determining whether the exclusive dealing clause breached s. 27. Under the RRC model, a court only considers efficiency justifications after the two limbs of the model are met.

Summary of RRC to Fisher and Paykel:

A court using an RRC model would not condemn F&P's exclusive dealing

contract. The first limb is not met as the exclusive dealing contract did not significantly and substantially raise rivals' costs. The model seems a useful analytical tool and provides a coherent economic analysis of exclusive dealing. The model considers everything the High Court, using traditional analysis, did. The High Court has been indirectly criticised for inter alia not providing adequate principles which subsequent courts could follow when analysing exclusive dealing.¹⁷⁵ Arguably the RRC model provides such principles and a strong economic underpinning of the case.¹⁷⁶ The case shows the model is not the simple two-stage test Krattenmaker and Salop suggest. Each of the two stages has several independent steps. The weakness of the test is that it does not sufficiently take account of efficiencies. Courts balance the pro and anticompetitive effects of exclusive dealing under s. 27. Efficiencies play a large part in this. However, under the RRC model they are only considered at the end. However, had the High Court decided the case under s. 36, it need not have considered efficiencies.

It appears New Zealand courts could usefully employ the model in analysing exclusive dealing. However, a s. 27 case may not require a plaintiff to show the exclusive dealing clause gives the predator market power.

RESPONSE TO F&P'S CRITICS

175 Farmer, Competition Law, RECENT LAW REV. 203, 212 (1990).

176 Hampton, Aspects of the Commerce Act 1986, in BUTTERWORTHS COMMERCIAL LAW IN NEW ZEALAND 635, 766 (A. Borrowdale and J. Farrar eds. 1992).

Commentators - notably Professor Warren Pengilley¹⁷⁷ and Rex Ahdar¹⁷⁸ have severely criticised Fisher & Paykel. Their criticisms are many but perhaps may be condensed as saying that the decision, in their view, was not only outside the mainstream of law and economics on exclusive dealing, but outside the river basin. I disagree. Not only, in my opinion, was Fisher & Paykel perfectly consistent with overseas authority, but it also represents well reasoned and contemporary economic thinking on exclusive dealing. The RRC model finds nothing wrong with Fisher & Paykel. If the decision was wrong, the model is flawed.

Professor Pengilley:

"Professor Pengilley's criticisms are many. He first says that Professor Baxter's submissions on U.S. law were misleading as they were "not related to the factual context of the cases involved".¹⁷⁹ He argues in some cases that the Baxter conclusions as submitted cannot be drawn at all.¹⁸⁰ Before this, he makes the obvious point that a principle in one case cannot be applied to another, unless there are factual similarities in each of the cases.¹⁸¹ I agree

177 Pengilley, Product Exclusively in New Zealand : The Fisher & Paykel Decision - Enlightened Reasoning or Competition Naivety? paper presented at the second annual workshop of the Competition Law and Policy Institute of New Zealand, Wellington, Park Royal Hotel, 11 August 1991.

178 Ahdar, *supra*, note 72.

179 Pengilley, *supra*, note 177, at 59.

180 Ibid.

181 Id. at 55-56.

entirely. However, as mentioned above, Professor Pengilley argues the U.S. law, Professor Baxter cited, has significantly different facts from Fisher & Paykel.¹⁸²

F&P had a market share of between 75-85 per cent. Professor Pengilley states that: "If exclusive dealing were to be regarded as legal in the U.S. when engaged in by a company with such a market share it might be thought that at least one American case holding and involving a company with a vaguely similar market share to that of F&P might have been able to be found".¹⁸³ One must make the point that it will be difficult to find U.S. firms with similar market shares to F&P. New Zealand industry is much more concentrated, consequently market shares will be larger.

However, Professor Pengilley is correct in stating Professor Baxter did not refer to such cases - but they exist. As mentioned above, Barry Wright Corp.¹⁸⁴ involved the defendant having a share of 80 per cent, yet the First Circuit Court of Appeals upheld the requirements contract. City of Chanute¹⁸⁵ concerned a natural gas pipeline company that controlled the only interstate pipeline serving the plaintiffs, a group of local municipal gas utilities. Indeed, the plaintiffs alleged the defendant was an essential facility. The Tenth Circuit Court of Appeals upheld the defendant's full requirements contract with the plaintiffs. As mentioned above courts have upheld exclusive dealing by firms

182 Id. at 59.

183 Ibid.

184 724 F. 2d 227 (1st Cir. 1983).

185 955 F. 2d 641 (10th Cir. 1992).

with over 40 per cent market share.¹⁸⁶

Fleer Corp. v Topps Chewing Gum, Inc.¹⁸⁷ involved exclusive licensing contracts between the defendant baseball card seller and every major league baseball player. The defendant had all the market for baseball cards sold with bubblegum. The Third Circuit Court of Appeals upheld the contracts, as the plaintiff had alternative outlets for its cards. Competitive licences were available for cards sold without nonconfectionery goods and competitors could sign minor league players.

Even cases where the defendant held a market share similar to F&P can be easily distinguished. Oltz v St Peters Community Hospital¹⁸⁸ involved the hospital entering into exclusive dealings contracts for anaesthesia services. The plaintiff was an anaesthetist who was excluded. The hospital had 84 per cent of hospital admissions in the area. The Court struck down the exclusive dealing contract, as the hospital was the only effective source of anaesthesia services in the market. It is easier for F&P's rivals to find retailers than it was for Dr Oltz to find a new hospital.

Professor Pengilley, then accuses Professor Baxter of having misrepresented Standard Oil.¹⁸⁹ He says Professor Baxter is incorrect when he said "Standard stopped just short of ruling exclusive dealing was illegal per

186 See, *supra*, notes 120 and 121.

187 658 F. 2d 139 (3rd Cir. 1981).

188 656 F. Supp. 760 (D. Mont. 1987), *aff'd* 861 F. 2d 1440 (9th Cir. 1988).

189 Pengilley, *supra*, note 177, at 61.

se".¹⁹⁰ Professor Pengilley then quotes Justice Frankfurter's lists of possible benefits of exclusive dealing. He says "It is difficult to characterise such observations as stopping" just short of ruling exclusive dealing ... illegal per se.¹⁹¹

Pengilley has not fully quoted Professor Baxter's statement on the case. Professor Baxter actually said Standard stopped just short of ruling that the exclusive arrangements ... were unlawful per se whenever a substantial dollar volume of commerce was affected".¹⁹² This is entirely correct. Although Justice Frankfurter noted exclusive dealing may have competitive effects he held they were too difficult for courts to assess.¹⁹³ Thus, exclusive dealing is illegal by proof that competition has been foreclosed in a substantial share of the line of the commerce affected. Once a plaintiff had established that, the procompetitive effects of exclusive dealing were irrelevant. In Standard Justice Frankfurter found the requirements contracts which foreclosed 6.7 per cent of the defined market affected a substantial share of commerce. If that is not a virtual per se rule - nothing is. As noted above Justice Jackson, in his dissent, accused the majority of establishing a per se rule.¹⁹⁴ NonChicago School commentators have said the same.¹⁹⁵

190 Ibid.

191 Id. at 62.

192 Statement of Professor Baxter to High Court of New Zealand at 14.

193 See, supra, note 91.

194 See, supra, note 93.

195 ROSS, supra, note 35, at 312.

Pengilley then says Professor Baxter misrepresents Tampa by failing to mention that only a 0.77 per cent market share was involved. He states Professor Baxter implies that exclusive dealing is virtually legal in all circumstances when he comments in relation to Tampa that the Court held: "a 20-year-contract involving millions of dollars of commerce was not objectionable."¹⁹⁶ Here again, Pengilley does not fully quote Professor Baxter. Professor Baxter actually said "the Court upheld a 20-year exclusive supply arrangement affecting hundreds of millions of dollars on the ground that the manufacturers rivals were not, given the market circumstances, significantly disadvantaged".¹⁹⁷ Professor Baxter specifically states "given the market circumstances". He hardly says Tampa gives carte blanche to exclusive dealing.

Pengilley then chides Professor Baxter for not quoting Twin City Sports Service¹⁹⁸ which Pengilley claims, represents current U.S. law and is relevant to F&P's arrangements and which could possibly run counter to the validity of F&P's ties.¹⁹⁹ With respect, Twin City is inapplicable to F&P. Indeed it is hard to imagine a more distinguishable case.

Twin City sold food, drinks and other items, under concession contracts, to spectators in sports stadiums. It controlled 24 per cent of the concession franchises throughout the United States. Finley owned a professional baseball team which had contracted with Twin City for its concession services. The term

196 Pengilley, *supra*, note 177 at 62.

197 Baxter, *supra*, note 192, at 15.

198 676 F. 2d 1291 (9th Cir. 1982), cert denied, 459 U.S. 1009 (1982).

199 Pengilley, *supra*, note 177, at 62-63 and 79.

of the agreement was ten years. It was possible that they could last a hundred years, as some contracts provided that if Twin City did not earn a stipulated minimum return, then the length of the contract would be automatically extended.²⁰⁰ The contracts also had, "follow the franchise" clauses, so that if the team moved cities or changed owners, Twin City's concession contracts would continue. Twin City also coercively induced teams to enter these contracts by offering large, long term loans at favourable interest rates and/or cash services. All these factors - not only the 24 per cent market share - led the Court to strike down the contracts. The exclusivity of the contracts was not at issue. The contract's duration and means by which Twin City induced such duration were the primary concern. The Court did not expressly address exclusivity. It said the exclusive nature of Twin City's rights to sell concessions at a particular amount or facility was not the subject of antitrust enquiry in this case. Indeed, in a footnote the Court expressly stated "we make no judgement as to the propriety of the exclusive nature of the franchise agreement".²⁰¹ Indeed, the Court did not suggest a team was required to have two or more concessionaires. It condemned the contract's length as being unreasonable, as they far exceeded the time needed to recapture Twin City's investments in the contract.²⁰²

F&P's contracts, on the other hand, were 30 days - not 10 to 100 years. There was no evidence of F&P offering lucrative inducements for its distributors

200 676 F. 2d 1291, 1296 (9th Cir. 1982).

201 Id. at 1304.

202 Id. at 1304.

to contract with it. If distributors moved or sold, F&P's contracts did not have to continue. Thus, with respect there was nothing sinister in Professor Baxter's not referring to Twin City. Indeed, Twin City's condemnation of an exclusive dealing contract when the defendant had 24 per cent of the market may well be the high water mark of hostility to exclusive dealing.²⁰³ Pengilley also criticises Professor Baxter's opinion of U.S. law that short term exclusivity is always or nearly always legal.²⁰⁴ He however offers no case law in which a court struck down an exclusive dealing clause of similar length to F&P's. The only case I could find where a court enjoined contracts of equivalent length was U.S. v Dairymen, Inc.,²⁰⁵ where the Court enjoined requirements contract covering a large percentage of the market though they only lasted 30 years to one year. However, this case predates Roland Machinery.²⁰⁶

Pengilley accuses the Fisher & Paykel High Court of being "legalistic and somewhat commercially naive"²⁰⁷ believing a dealer could terminate F&P's arrangements without penalty. He regards that no director had ever terminated as showing the enormous difficulties the distributor has in switching. The response to this must be, while that was undoubtedly true before import tariffs were removed, it is not true now. Who were the distributors to turn to

203 I was unable to find a U.S. case after 1982 where a court had condemned exclusive dealing with such a low market.

204 Pengilley, *supra*, note 177, at 61.

205 1982-2 Trade Cas. (CCH) paras 65, 641 and 65, 704 (W.D. Ky 1983), *aff'd* without published opinion 758 F. 2d 654 (6th Cir. 1984).

206 749 F. 2d 380 (7th Cir. 1984).

207 Pengilley, *supra* note 177, at 74.

previously? The only alternatives were expensive imports. That is no longer the case. Distributors can choose between such companies as Hoover and Simpson. Indeed since the High Court decision dealers have switched in significant numbers from F&P.²⁰⁸

Pengilley also criticises Professor Baxter for understating the anticompetitive effects of exclusive dealing. Professor Baxter says there are only two circumstances where anticompetitive effects of exclusive dealing can occur. One is when a company with monopoly power buys up all or substantially all distribution capacity. The second is when a party with monopoly power buys up more distribution capacity than it really needs.²⁰⁹ Pengilley criticises Professor Baxter for not citing any authority for that.²¹⁰ Professor Baxter's view is that there are no anticompetitive effects from exclusive dealing unless a new entrant is put to inordinant expense in obtaining new outlets. Contrary to Pengilley, there is economic support for Professor Baxter's view. Baxter's two grounds for exclusive dealing's anticompetitive nature are the RRC model's, bottleneck and real foreclosure scenarios. Baxter's inordinant expense criteria is merely another way of saying raising rivals' costs. Recent U.S. law, including the Department of Justice's vertical restraints guidelines is perfectly consistent with Professor Baxter's submissions.²¹¹ As, arguably, is Professor Williamson when he states

208 SUNDAY TIMES, MARCH 1993 p 17.

209 Baxter, *supra*, note 192, at 17.

210 Pengilley, *supra*, note 177, at 67.

211 U.S. Department of Justice Vertical Restraint Guidelines (Jan. 23 1985) para 3.2.

exclusive dealing is only worthy of competition law concern when indulged in by a structural monopolist in a market where entry is difficult.²¹²

As I have argued above, a court applying the raising rivals' costs model would not have found that Fisher and Paykel had indulged in anticompetitive behaviour. It would find so without considering F&P's efficiency justification.

Pengilley argues that had the High Court properly considered U.S. law, it would have reached a different result.²¹³ With respect, I disagree. The High Court found the following factors relevant in deciding:²¹⁴

- (1) Despite F&P having a large market share and significant market power, the market was competitive.
 - (2) Exclusive dealing can be procompetitive.
 - (3) The exclusive dealing did not significantly foreclose retailers.
 - (4) The exclusive dealing clause was of short duration, and easily terminable.
- U.S. Courts have found all these factors relevant in upholding exclusive dealing.²¹⁵

Pengilley's criticism of Professor Baxter in quoting Sylvania is puzzling.²¹⁶ Sylvania revolutionised the U.S. Courts thinking of nonprice vertical restraints. That it did not involve exclusive dealing, does not decrease its importance. Indeed, it certainly supercedes Standard Stations and Tampa.

212 Williamson, *supra*, notes 41 and 42.

213 Pengilley, *supra*, note 177, at 63.

214 [1990] 2 NZLR 731 at 767.

215 See, *supra*, notes 122-134.

216 Pengilley, *supra*, note 177, at 65.

Indeed, many cases now no longer refer to these decisions and simply undertake a rule of reason analysis based on Sylvania.

Pengilley also criticises the High Court for not following Ford.²¹⁷ However, this criticism depends on Ford being good law. For the reasons mentioned above, I submit it is not. As the High Court noted, the case is also distinguishable, as site ties applied to 45 per cent of Ford's dealers, there were import barriers to entry, and cars cost more than whiteware, making it more financially difficult to enter the dealership market.²¹⁸ Indeed, with the benefit of hindsight, one must wonder whether F&P's rival's counsel made a tactical error in so heavily relying on Ford.

Rex Adhar:

Ahdar is even more critical of the Fisher & Paykel decision than Pengilley. He claims the decision may be the beginning of the emasculation of the New Zealand antitrust.²¹⁹ While Ahdar makes many of the same criticisms as Dr Pengilley - he does not have a framework or method to his criticisms. His article is more a polemic against the victory of the forces of darkness as represented by the Chicago School. However, I shall comment on some of his criticisms.

He regards the decision as being inconsistent with overseas jurisdiction. I have already argued it is not inconsistent with U.S. law. He criticises the High

217 Id. at 91-94.

218 [1990] 2 NZLR 731 at 762.

219 Ahdar, *supra*, note 72, at 54.

Court for not quoting Hyde as recent Supreme Court authority on exclusive dealing.²²⁰ He seems to imply that Hyde and Fisher & Paykel are mutually exclusive. Justice O'Connor said: "Exclusive dealing is an unreasonable restraint on trade only when a significant fraction of buyers or sellers are frozen out of a market by the exclusive dealing".²²¹ This is consistent with Fisher & Paykel. Only a minority of the Supreme Court discussed the case as an exclusive dealing one. The majority regarded it as involving tying. Given that, the High Court had reason not to quote Hyde.

Fisher & Paykel contains no evidence that its rivals were frozen out of the market. As the High Court noted, they could obtain alternative channels of distribution cheaply. Indeed Fisher & Paykel's rival's success in decreasing Fisher & Paykel's market share despite the exclusive dealing shows they were not frozen out.²²²

Ahdar also quoted Canadian law²²³ and seems to imply that a Canadian Court would decide Fisher & Paykel differently. The case law does not support this. The Nutra Sweet case is immediately distinguishable. Fisher & Paykel was not the world's largest manufacturer. It did not have economies of scale up to a third of the world's production. It did not offer substantial discounts to its suppliers. It had no meet or release or most favoured nation clauses. No one claimed Fisher & Paykel coerced its distributors to sign. Fisher & Paykel's

220 Id. at 44.

221 466 U.S. 2, 45 (1984).

222 See, supra, note 208.

223 Ahdar, supra, note 72, at 25-26.

exclusive dealing agreements were one-quarter of the length of Nutra Sweet's. Ahdar neglects to mention the Tribunal noted that had Nutra Sweet not offered the rebates and required long time use of its logo, then the exclusive dealing agreement might not have been anticompetitive.²²⁴

He significantly fails to mention Bombardier, which is more similar to Fisher & Paykel. The Commission's test is remarkably similar to the Fisher & Paykel situation. Entering the snowmobile market is remarkably similar to entering the whiteware market, in that it is easy. Both Bombardier and Fisher & Paykel face competition from internationally larger rivals. Neither had the protection of import tariffs. As in Fisher & Paykel, the Commission in Bombardier recognised exclusive dealing has procompetitive effects.

Ahdar like, Pengilley, argues Ford is consistent with overseas authority.²²⁵ For reasons set out above, I disagree.

He also quotes European law²²⁶ and seems to imply that this is relevant in the Fisher & Paykel case. With respect, I disagree. Much of the litigation under European law involves applications for exemption. The European Commission, in a note, has held that provided the turnover of the parties to the exclusive dealing, including companies connected with them, does not exceed 200 million ECU's and the market share within the common market, or a substantial part of it, is below 5 per cent, then article 85(1) does not apply.²²⁷ If this does

224 See, supra, note 145.

225 Ahdar, supra, note 72 at 49.

226 Id. at 23-25.

227 "Notice on agreements of minor importance" [1986] O. J. C231/2.

not apply the company has to apply for an exemption. This is a far lower threshold than anywhere else in the world. Commentators have also extensively criticised the Commission's practice. Their basic criticism is that the EEC Law of Competition in relation to vertical restraints does not have a rule of reason.²²⁸ Pro and anticompetitive effects are not assessed as fully as they are in other jurisdictions. The market shares which Ahdar refers to in his European examples shows this is true. One must also note that in the cases Ahdar quotes there were allegations that the supplier induced the contracts by offering monetary inducements and discounts. Fisher and Paykel did not.

Ahdar's weakness is to assume exclusive dealing with a 75-85 per cent market share automatically means the exclusive dealing is bad. This appears to be the outdated Standard Station's thinking. It is the simple deciding of cases by formulae or on the basis of line drawing.

He also claims that Fisher & Paykel may have facilitated a dealer's cartel.²²⁹ Fisher & Paykel dealers formed themselves into a dealers' support association and supported Fisher & Paykel's bid for authorisation. This association presumably helped maintain a cartel for Fisher & Paykel's whiteware goods. He offers as evidence "an informal survey of four Fisher & Paykel

228 Faull, Joint Ventures under the EEC Competition Rules, 5 ECLR 358, 362 (1984); Gyselen, Vertical Restraints in the Distribution Process : Strength and Weakness of the Free National Under EEC Competition Law, 21 CMLR 648 (1984); Hawk The American (Antitrust) Revolution : Lessons for the EEC?, 9 ECLR 53 (1988). Korah, The Rise and Fall of Provisional Validity - The Need For a Rule Reason in EEC Antitrust, 3 NW. J. Int'l L. & BUS., 320, 340 (1981).

229 Ahdar, *supra*, note 72, at 11.

dealers in Dunedin".²³⁰ He found these practised de facto resale price maintenance.

With respect, such a survey shows and proves nothing. However, his point is theoretically possible. However, recent economic analysis suggests that his proposed cartel offers no anticompetitive threat.

Professor Wesley Liebeler argues that such intrabrand cartels do not decrease output and therefore do not merit antitrust concern.²³¹ He argues "... they do not operate to increase market share directly beyond the level already held by the supplier of the particular brand of product involved".²³² He argues that a monopoly supplier will charge the maximum price it can obtain for its profits, i.e. it will reduce output to the profit maximising quantity. If it retailers for a cartel they will not be able to reduce output any further. All that will happen is the distribution of monopoly profits will change, viz; the retailers will take more.

Price to consumers will not change. Such cartels may form to alleviate free rider problems and increase efficiency or they may be a blatant price fixing cartel. Liebeler argues courts cannot distinguish them, so should not forbid them.²³³ This argument only applies to reseller cartels which involve the

230 Id. at footnote 63.

231 W. Liebeler, Intrabrand 'Cartels' under GTE Sylvania, 30 U.C.L.A. Law Rev., 1 (1982).

232 Id. at 5.

233 Ibid.

supplier.²³⁴ This appears to be the case with Ahdar's postulated Fisher & Paykel dealer's cartel.

He criticises the High Court's concept of competition.²³⁵ He implies that the High Court has adopted efficiency as a sole meaning of competition, i.e. adopted Chicago School thinking. He claims that is inappropriate. Efficiency is but one of the goals of competitive law. Innovation and the diffusion of concentrated power are others. The Commerce Act stated goal is the promotion competition. Chicagoans' efforts to change the objective have been foiled.²³⁶ However, one can strongly argue efficiency is the Commerce Act's goal. I have so argued in Chapter I of this dissertation.

Ahdar congratulates the Court for rejecting Fisher & Paykel's free rider argument.²³⁷ He notes that had they been relevant Fisher & Paykel would have used them for brown goods in Australia. Commissioner Vautier in her minority decision in the Commerce Commission said exclusive dealing contracts were unnecessary for brown goods as most were imported and Fisher & Paykel did not design them.²³⁸ Another reason may be that Fisher & Paykel's distributors did not want them. The exclusive dealing contracts were agreements between Fisher & Paykel and its dealers. Fisher and Paykel did not coerce them. Its dealers voluntarily agreed to them. They may not have wanted them

234 Ibid.

235 Ahdar, *supra*, note 72, at 42-43.

236 Id. at 43.

237 Id. at 46-47.

238 (1990) 2 NZBLC (Com) at 104, 451.

for brown goods. However, all this is speculation as there was no evidence on that point. As to why Fisher & Paykel did not have exclusive dealing in Australia, perhaps the answer is, that with a precedent like Ford what lawyer would recommend exclusive dealing.

Despite American courts having held that prevention of free riding is a valid antitrust concern and must be taken into account in assessing arrangements courts do not automatically accept free rider arguments. Perhaps the best example of this is Chicago Professional Sports Limited Partnership v National Basketball Association.²³⁹ This involved an NBA rule limiting the number of games which could be shown on a super station from 25 to 20. The NBA offered three free rider explanations for the rule. The Seventh Circuit Court of Appeals assessed these free rider explanations and found them inadequate.²⁴⁰ Undoubtedly Ahdar would approve of this. The author of this decision? Judge Easterbrook.

CONCLUSION:

Louise Longdin, in a case note accuses the High Court of being under the tight yoke of the Chicago School Model of Market Behaviour.²⁴¹ If this means deciding cases under s. 27 on the basis of demonstrable effect, rather than on formulated line drawing based on market share, and basing competition law

239 961 F. 2d 667 (7th Cir. 1992).

240 Id. at 675.

241 Longdin, Regulation of Exclusive Dealing in New Zealand Chicago Triumphs?, [1990] 12 ECLR 189.

policy on market considerations; applying contemporary economic analysis on overseas case law, she is correct. Long may the yoke remain tight.

The RRC model's critics are correct in saying that it does not offer anything substantially new to antitrust analysis. All the factors a court takes into account under the RRC model are taken into account by courts deciding cases on the basis of previous case law. However, the RRC model offers a more coherent and tightly structured method of analysis. Its weakness for s. 27 is that it does not sufficiently take account of efficiencies. Efficiencies are vital to assessing the effect of an anticompetitive arrangement. They need not be under s. 36. If a dominant firm claims its purpose for exclusive dealing was to obtain efficiencies, a court could use the RRC model to assess whether the dominant firm gained power over price. If so, it is likely it had an anticompetitive purpose and its exclusive dealing was unnecessarily restrictive. This shows how the model is useful in s. 36. A dominant firm that practises exclusive dealing will always claim its purpose was to increase efficiency. If, however, the exclusive dealing leads to the dominant firm having power over price consumers have suffered. Courts could infer an anticompetitive purpose. If consumers suffer in the form of higher prices courts should intervene. The RRC model shows when they should intervene. Courts should ignore any claimed efficiency by a dominant firm in such a case.

CHAPTER XV

CONCLUSION

Strategic nonprice predation merits antitrust concern. Dominant firms can engage in it, to the detriment of consumer welfare. The RRC model demonstrates how. Its most important feature is showing how a dominant firm can gain power over price, and prevent price from falling. Although price may stay the same after a dominant firm's action, consumers suffer as price would have fallen even further. This insight shows that predation is not irrational. A predator can pay for its conduct from the revenue it saves by preventing prices falling. It is in a predator's interests to prevent price falling. Thus, the RRC model is relevant to any New Zealand court considering a predation claim under s. 36. The concept of preventing price from falling is particularly relevant in assessing price squeezes and refusals to supply rivals. It helps show how such conduct can harm consumer welfare. The model is of no use in assessing refusals to supply nonrivals. Such conduct does not raise rivals' costs.

The model is consistent with courts' interpretation of s. 36. In many cases if a dominant firm gains power over price, courts should infer an anticompetitive purpose. They should do so over any dominant firm's purported efficiency justification. However, the model is not a sinecure. A dominant firm's conduct which gives it the power over price may actually benefit consumers. I have argued product innovation and advertising are two such instances. To condemn such behaviour using the RRC model would ultimately chill and deter beneficial

practices. In other cases such as capacity expansion and hiring, the RRC theory is useful. However, it should not be the sole determinant. A court should assess this conduct using the RRC theory together with other factors. By itself the theory could condemn much beneficial and competitively neutral behaviour. In relation to abuse of judicial and administrative processes the theory shows how it can be anticompetitive. It is a useful insight to assessing such actions. The RRC model works particularly well with exclusive dealing. Courts should assess exclusive dealing under the model. The theory is likely to become more common in antitrust cases. It is relevant to s. 36.

The model is not unduly complex for courts to employ. It uses economic theory. That can be no criticism. As Professor Paul De Long notes: "Antitrust litigation not only needs economic analysis, antitrust litigation is becoming economic analysis".¹ Justice Thurgood's complaint about judges being unaccustomed to "rambling in the wilds of economic theory"² can not be valid in 1994. Indeed, it is wrong in relation to New Zealand where economists can sit as lay members of the High Court when hearing Commerce Act claims.

In many cases, the RRC model achieves the same result as conventional antitrust. That is no criticism. The beauty of the model is that it provides an economic underpinning to the cases. It also provides something extra for courts to consider. The theory is not simply "old wine in new bottles". It is a blend of old and new wine in new bottles. New Zealand courts could profitably drink

1 De Long, The Role If Any Of Economic Analysis In Antitrust Litigation, 12 SW. U. L. REV., 298, 320 (1980).

2 For the original, see U.S. v Topco Assocs. 405 U.S. 596, n. 93 (1972) (Marshall J.).

from the theory when considering s. 36 cases.

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